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REVIEW OF THE MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE (MiFID)

Important comment: this document is a working document of the Commission services for discussion and consultation purposes. It does not purport to represent or pre-judge the formal proposal of the Commission.

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1. INTRODUCTION

The Markets in Financial Instruments Directive (MiFID), applied since November 2007, is a core pillar in EU financial market integration. It consists of a framework Directive (Directive 2004/39/EC)¹, an Implementing Directive (Directive 2006/73/EC)² and an Implementing Regulation (Regulation No 1287/2006)³. This consultation focuses on the revision of the framework Directive 2004/39/EC while outlining when needed the possible changes in the implementing legislation which would follow at a later stage. All measures to be proposed for implementing legislation will be drawn up in accordance with relevant parts of the Treaty on the Functioning of the European Union and the case law of the European Court of Justice⁴. When implementing acts are considered, it is without prejudice to the power of the Commission to decide on the legal form of the implementing act, including technical standards.

MiFID's main objectives are to improve the competitiveness of EU financial markets by creating a genuine single market for investment services and activities, and to ensure a harmonised, high degree of protection for investors in financial instruments, such as shares, bonds, derivatives and various structured products. Greater competition across Europe in the provision of services to investors and between trading venues is intended to contribute to deeper, more integrated and liquid financial markets, to drive down the cost of capital for issuers, to deliver better and cheaper services for investors, and thus to contribute to economic growth and job creation.

Almost three years after it became applicable, MiFID has already brought about significant changes in spite of the worst financial crisis in decades. The Directive has driven further competition and innovation and better protection and services for investors. Competition has emerged between trading venues and at the same time the Directive has introduced harmonised requirements in terms of fair and orderly trading and uniform transparency requirements for shares. Also, investment firms now have the freedom to provide investment services across the EEA if they comply with rigorous investor protection requirements. The Directive has generally resulted in higher and more comprehensive investor protection requirements.

There is evidence that greater competition under MiFID between trading venues has resulted in lower trading costs per transaction, reduced bid-ask spreads and faster trading times. There is more choice for investors and greater opportunities for pan-European trading i.e. an investor can now access a single venue to trade in the most liquid shares across the EEA rather than being required to connect to many different venues. As well

1 Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments (OJ L 145, 30.4.2004)

2 Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (OJ L 241/1 2.09.2006)

3 Commission Regulation (EC) No 1287/2006 of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards record-keeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading and defined terms for the purposes of that Directive (OJ L 241/1 2.09.2006)

4 Articles 290 and 291 of the TFEU (OJ C 83/1, 30.3.2010) and Judgment of 13 June 1958, Meroni / ECSC High Authority (9/56, ECR 1957-1958 p. 133)

as breaking national monopolies, there has been increased competition between clearing houses with new clearing services being set up to clear for the newer trading venues. New services have also emerged in the public reporting of trades, another area where MiFID broke existing monopolies.

Positive feedback has been received from market participants although many emphasise that the effects of the Directive are still a work in progress and that the full benefits to markets and investors from the Directive will only be fully realised over a longer time period.

Still, market developments and experience amid the financial crisis demonstrate that the key organising principles of MiFID – a regulatory framework centred on shares and regulated markets – need updating. This need has also been recognised at the G20 level and thus important third country jurisdictions are also involved in a reform process in this area. The need to adapt regulation to serve a more complex market reality characterised by increasing diversity in financial instruments and methods of trading is reflected in all major recent EU reforms in the financial services area, including the review of the Market Abuse Directive,⁵ and the proposals on OTC derivatives, central counterparties and trade repositories,⁶ and on short-selling and certain aspects of credit default swaps⁷ adopted by the Commission on 15 September 2010.

Further, developments in specific areas such as commodity markets call for targeted reforms, both in the regulation of commodity derivative markets covered by MiFID and other relevant legislation and in the regulation of physical markets.

More specifically, a number of overlapping factors underline the need for a review.

- First, the revision of MiFID is an essential part of the structural reforms aimed at establishing a safer, sounder, more transparent and more responsible financial system working for the economy and society as a whole in the aftermath of the financial crisis.⁸
- Second, as part of the consensus under the G20⁹ to tackle less regulated and more opaque parts of the financial system, significant extensions are required in MiFID as regards the organisation, transparency and oversight of various markets segments, especially in those instruments traded mostly over the counter (OTC).¹⁰ The amendments to MiFID on these topics would be complementary to the new framework on the infrastructures for derivatives markets included in the

5 For which a consultation was carried out in summer 2010. For further information see http://ec.europa.eu/internal_market/consultations/2010/mad_en.htm

6 COM(2010) 484

7 COM(2010) 482 final

8 See Communication by the Commission dated 2nd June 2010 on Regulating financial services for sustainable growth (COM (2010) 301)

9 See for example Leaders' statements of Pittsburgh Summit 24-25 September 2009 and Seoul Summit 11-12 November 2010, <http://www.pittsburghsummit.gov/mediacenter/129639.htm>
http://media.seoulsummit.kr/contents/dlobo/E1._Seoul_Summit_Leaders_Declaration.pdf

10 As a result, on 20 October 2009, the Commission issued a Communication on ensuring efficient, safe and sound derivatives markets: future policy actions (COM(2009)563 final).

legislative proposal on OTC derivatives, central counterparties and trade repositories.

- Third, in order to support the original purpose of efficient and integrated financial markets and to take account of rapid changes in market structure and technological development, a number of unforeseen developments that could affect the smooth and efficient functioning of EU equity markets need to be addressed.
- Fourth, amid the financial crisis, improvements to MiFID are also necessary in order to further strengthen high standards of investor protection throughout the EU.
- Finally, in line with proposals from the de Larosière group and ECOFIN,¹¹ the EU has committed to minimise, where appropriate, discretions available to Member States across EU financial services directives. This will be a common thread across all areas to be covered by the review of MiFID and will contribute to establishing a single rulebook for EU financial markets, help level the playing field between Member States, improve supervision and enforcement, reduce costs for market participants, and improve conditions of access and competition across the EU.¹²

CESR has conducted various consultations and has been providing technical advice¹³ to the Commission in the context of the MiFID review and responses to the Commission request for additional information, where further areas for analysis were also included.¹⁴

This consultation document is divided into the following sections:

1. Addressing developments in market structures;
2. Improvements to pre- and post-trade transparency in EU equity markets, and new measures on pre- and post-trade transparency in non-equity markets;
3. Improvements regarding market data consolidation;
4. Measures specific to commodity derivative markets;
5. Clarifications and necessary extensions to transaction reporting;
6. Investor protection and provision of investment services;
7. Further convergence of the regulatory framework and supervisory practices;
8. Reinforcement of key supervisory powers.

11 See Report of High-level Group on Financial Supervision in the EU chaired by Jacques de Larosière, 25 February 2009, and Agreed Council conclusions on Strengthening EU Financial Supervision, 10 June 2009.

12 Specific national discretions which have not been used by any Member State will not be part of this consultation document.

13 See CESR Technical Advice to the European Commission in the context of the MiFID Review and Responses to the European Commission Request for Additional Information, 29 July and 13 October 2010, www.cesr.eu

14 Further, regulatory changes in response to similar concerns have been proposed or are being considered in various other countries as well. The Commission is in close contact with authorities in many of these countries. The Commission services are also following closely the work of the European Parliament, which is in the process of adopting an own-initiative report touching upon several relevant topics.

This consultation is open until 2 February 2011. Responses should be addressed to markt-consultations-mifid@ec.europa.eu. The Commission services will publish all responses received on its website unless confidentiality is specifically requested. For administrative purposes please clearly state, in the email text, the following information:

- Name of organisation/person;
- If you are registered with the Commission as an "interest representative"¹⁵ your identification number;
- Relevant contact details; and
- Confirmation that you acknowledge that your response will be published.

The purpose of this public document is to consult market participants, regulators and other stakeholders. Responses to this consultation will provide important guidance for the Commission services in preparing a formal Commission proposal, which is currently scheduled for adoption in spring 2011. The proposal will be accompanied by an impact assessment.

2. DEVELOPMENTS IN MARKET STRUCTURES

Conceptually, MiFID is predicated largely on markets in shares, in which regulated exchanges have traditionally been playing a central role. The emergence of alternative trading functionalities, rapid technological developments, and the growing spotlight on OTC trading all challenge this paradigm. It is therefore necessary to update the Directive to provide a more suitable, clear, and robust regulatory coverage of all different types of trading facilities, technological applications, and methods of execution which exist today or may emerge in the foreseeable future. Together with the considerations below on improving pre- and post-trade transparency in both equity and non-equity markets, providing for the comprehensive consolidation of market data in the more fragmented and competitive trading environment generated by MiFID, as well as enhancements to investor protection and supervision, these changes aim to support market liquidity and efficiency, and improve investor confidence.

2.1. Defining admission to trading

The concept of a financial instrument being "admitted to trading" on a trading venue is a central concept that is used in MiFID and in other directives relating to financial services. In order to add clarity to this concept and cope with recent developments in the financial markets (notably more instruments being admitted to trading on multilateral trading facilities (MTFs)) a specific definition could be included in Article 4 of the MiFID framework directive. Admission to trading would be defined as the decision by the operator of a regulated market, MTF, or organised trading facility (see section 2.2 below) to allow a financial instrument to be traded on its systems. This would include a decision that allows any conditional trading to take place on its systems.

¹⁵ <https://webgate.ec.europa.eu/transparency/reg/in/welcome.do>

(1) What is your opinion on the suggested definition of admission to trading? Please explain the reasons for your views.

2.2. Organised trading facilities

MiFID is not prescriptive about where trades must be executed and provides flexibility and a choice for investors about where and how they wish to execute trades. Trading venues or platforms under MiFID are regulated markets, MTFs or systematic internalisers.¹⁶ In order to address evolving market practices and technological developments, and mitigate harmful regulatory arbitrage, a broad definition in MiFID could be introduced to suitably regulate all organised trading occurring outside the current range of MiFID venues.¹⁷ This could be accompanied by a change in the framework directive to ensure that the operation of an organised trading facility would become an investment service,¹⁸ for which authorisation is required.

The definition of an organised trading facility would capture any facility or system operated by an investment firm or a market operator that on an organised basis brings together buying and selling interests or orders relating to financial instruments. This would cover facilities or systems whether bilateral or multilateral and whether discretionary or non-discretionary. The definition would exclude facilities or systems that are already regulated as a regulated market, MTF or systematic internaliser.

Examples of organised trading facilities would include broker crossing systems and inter-dealer broker systems bringing together third-party interests and orders by way of voice and/or hybrid voice/electronic execution.¹⁹

The definition would be broad and capable of applying to new organised trading facilities that may emerge in the future. By definition, it would exclude pure OTC trading (i.e. bilateral trades carried out on an ad hoc basis between counterparties and not under any organised facility or system) as characterised in MiFID.²⁰ It would also exclude systems or facilities used simply to execute an order on an external trading venue or to route an order to an external trading venue.

2.2.1. General requirements for all organised trading facilities

Such an organised trading facility could be subject to certain core requirements with the possibility that for various sub-regimes there could be further relevant requirements

16 As defined in Article 4(1)(7), (14) and (15) of Directive 2004/39/EC

17 In Article 4(1) of Directive 2004/39/EC

18 In Annex I, Section A of Directive 2004/39/EC

19 Some of the systems captured here can be classified as so-called "dark pools" of liquidity (Cf. the IOSCO Consultation Report "Issues Raised by Dark Liquidity", October 2010, p. 4). Dark pools are trading systems where there is no pre trade transparency of orders in the system (i.e. there is no display of prices or volumes of orders in the system). Dark pools can be split into two types: systems such as crossing networks that cross orders and are not subject to pre-trade transparency requirements and trading venues such as regulated markets and MTFs that use waivers from pre-trade transparency not to display orders (see section 3.1.1. below).

20 Recital 53 of Directive 2004/39/EC wherein OTC trading is characterised as "ad-hoc and irregular and (...) carried out with wholesale counterparties and (...) part of a business relationship which is itself characterised by dealings above standard market size..."

applied if appropriate such as those discussed in sections 2.2.2 and 2.2.3 below. However, all of them would be subject to the following requirements:²¹

- a) A complete notification and description of the facility or system of the investment firm or market operator to the competent authority including, at least, details of the trades that may be executed using the system, the range of financial instruments it covers, the trading methodology, and the arrangements for post-trade processing;
- b) The competent authority would notify the European Securities and Markets Authority (ESMA)²², which would maintain a complete list of all such facilities and publish the details of the system on its website together with a unique code identifying the system for use in transaction reports to competent authorities and post-trade transparency reports to the public, where required in the relevant parts of MiFID (see sections 3 and 5 below);
- c) The adoption and publication of clear rules regarding access to the facility or system;
- d) The adoption of clear and effective arrangements for the identification and management of conflicts of interest that may arise from operation of the facility or system;
- e) The adoption of arrangements for the sound management of the technical operations of the facility or system, including the establishment of effective contingency arrangements to cope with risks of systems disruptions;
- f) The monitoring of all trading taking place on the facility or system with a view to identify conduct involving market abuse;
- g) The compliance with instructions from the competent authority to suspend or remove a financial instrument from trading under Article 41(2) of MiFID;
- h) For facilities offering trading in commodity derivative contracts, compliance with the reporting obligation in Section 5.1 below.

Finally, after reaching an asset-specific threshold an organised trading facility would convert to a MTF.

- (2) What is your opinion on the introduction of, and suggested requirements for, a broad category of organised trading facility to apply to all organised trading functionalities outside the current range of trading venues recognised by MiFID? Please explain the reasons for your views.**
- (3) What is your opinion on the proposed definition of an organised trading facility? What should be included and excluded?**

21 In addition to those in Article 13, to be included in Chapters I and II of Title II of Directive 2004/39/EC

22 Regulation (EU) No .../2010 of the European Parliament and of the Council establishing a European Supervisory Authority (European Securities and Markets Authority) amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC

- (4) **What is your opinion about creating a separate investment service for operating an organised trading facility? Do you consider that such an operator could passport the facility?**
- (5) **What is your opinion about converting all alternative organised trading facilities to MTFs after reaching a specific threshold? How should this threshold be calculated, e.g. assessing the volume of trading per facility/venue compared with the global volume of trading per asset class/financial instrument? Should the activity outside regulated markets and MTFs be capped globally? Please explain the reasons for your views.**

2.2.2. *Crossing systems*

Matching of client orders is an activity traditionally carried on by brokers. While such activities are still carried on manually by brokers, in the last few years, investment firms have increasingly developed automated systems to help internally match client orders where possible. Typically such systems (known as broker crossing systems) use algorithms to slice larger parent orders into smaller 'child' orders before they are sent for matching. Some systems will try to match only client orders while others also provide matching between client orders and house orders (with the permission of clients). If client orders are not matched internally they are then routed on to a trading venue for execution.

The execution of clients' orders is subject to client-oriented conduct of business rules,²³ but the activity of operating a system to match clients' orders is not regulated as a market unless it meets the criteria for being defined as a multilateral trading facility (MTFs).²⁴ Such systems can be viewed as a hybrid between a facility to assist execution of clients' orders and a multilateral system that brings together orders.

The Commission services consider it appropriate to define and create a new sub-regime for crossing systems within the family of organised trading facilities.²⁵ Such a regime would cover not only equities but also other types of financial instruments.

The Commission services consider it appropriate to clarify that if orders are entered into a crossing system not only by the operator but also by any third party, this would transform the system into a MTF and the relevant requirements including any pre-trade transparency would apply to the system. Similarly, if a broker executes client orders against its own proprietary capital within a crossing system then this would *prima facie* trigger the application of the systematic internaliser regime.

The new regime for crossing networks would be proportionate, take into account the hybrid nature of the business and that firms operating such systems are already subject to

23 Articles 19, 20, 21 and 22 of Directive 2004/39/EC

24 They are required for example to comply with conduct of business and best execution provisions as well as to publish transactions in shares admitted to trading on a regulated market, to have arrangements in place to prevent conflicts of interest from damaging clients' interests, and to notify competent authorities when they suspect a transaction might constitute insider dealing or market manipulation.

25 In Article 4 of Directive 2004/39/EC

client facing obligations, transaction reporting requirements and post-trade transparency requirements.

In addition to the requirements under Section 2.2.1 above, the Commission services consider that the sub-regime for such a system would specify that:²⁶

- a) The operator would add the identifier for its crossing system to post-trade information, when this is required under post-trade transparency provisions in MiFID, about transactions executed on the system. Operators would be required to make public aggregated information at the end of each day about the number, value and volume of all transactions executed using the system;
- b) The operator would identify in transaction reports whether the transaction was executed on the system.

(6) What is your opinion on the introduction of, and suggested requirements for, a new sub-regime for crossing networks? Please explain the reasons for your views.

(7) What is your opinion on the suggested clarification that if a crossing system is executing its own proprietary share orders against client orders in the system then it would prima facie be treated as being a systematic internaliser and that if more than one firm is able to enter orders into a system it would be prima facie be treated as a MTF? Please explain the reasons for your views.

2.2.3. Trading of standardised OTC derivatives on exchanges or electronic trading platforms where appropriate²⁷

Significant efforts are underway to improve the stability, transparency and oversight of OTC derivatives markets. As part of this, it has been agreed globally to ensure that, where appropriate, trading in standardised OTC derivatives moves to exchanges or electronic trading platforms.²⁸ At a minimum this would imply that trading on exchanges and electronic platforms becomes the norm when the market in a given derivative is suitably developed, and when the shift to such platforms furthers the G20 commitment²⁹ as well as provides benefits additional to those brought by greater standardisation, more central clearing and reporting to trade repositories in terms of transparency, competition, market oversight and price formation.³⁰

26 To be included in Chapters I and II of Title II of Directive 2004/39/EC

27 As stated in the Commission Communication on ensuring efficient, safe and sound derivatives markets: future policy actions (COM(2009)563 final), trading of OTC derivatives should be tackled in the MiFID review.

28 The September 2009 G20 summit concluded that "all standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest."

29 To increase transparency, mitigate systemic risk, and protect against market abuse.

30 While it is important to consider which different kinds of trading venues correspond to the G20 characterisation of exchanges and electronic trading platforms, this focus on the outcome renders the issue slightly less relevant. Therefore, it is to be anticipated that while different jurisdictions will continue to have diverging execution arrangements and requirements, they will make regulatory choices in favour of certain venues in accordance with internationally agreed principles, thereby minimising the risk of regulatory arbitrage.

Against this background, and taking full account of the views of the European Parliament³¹ and CESR³², the Commission services consider that the MiFID framework directive could be amended³³ to require all trading in derivatives which are eligible for clearing and sufficiently liquid to move either to:

- a) Regulated markets;
- b) MTFs; or
- c) A specific sub-regime of organised trading facilities, to be precisely defined in MiFID.³⁴

In order for a venue to qualify under this specific sub-regime, it could not only fulfil the conditions of section 2.2.1 above, but also fulfil the following criteria:³⁵

- a) Provide non-discriminatory multilateral access to its facility;
- b) Support the application of pre- and post-trade transparency as per section 3.4 below;
- c) Report transaction data to trade repositories;
- d) Have dedicated systems or facilities in place for the execution of trades.

ESMA, after issuing a decision pursuant to Article 4 of the proposal on a Regulation on OTC derivatives, central counterparties and trade repositories,³⁶ could assess and decide when a derivative which is eligible for clearing is sufficiently liquid to be traded exclusively on the various organised venues as defined above. ESMA could base its decision on, for example, the frequency of trades in a given derivative and the average size of transactions. As part of this ESMA would systematically also consider in which cases trading on exchanges or electronic trading platforms furthers the G20 commitment. This could be the case when, for example, there is an over-concentration of dealers in a specific derivative, a large-scale presence of buy-side investors in relation to sell-side participants in a given derivative, or when market oversight is shown to be hampered. The criteria for assessing sufficient liquidity and these other parameters would need to be specified at a subsequent stage.

(8) What is your opinion of the introduction of a requirement that all

31 European Parliament resolution of 15 June 2010 on derivatives markets: future policy actions (A7-0187/2010) calls for "as many eligible derivative products as possible [to] be traded on organised markets [and] for provision of incentives that encourage the trading of eligible derivative products on trading venues regulated by MiFID, i.e. on regulated markets and multilateral trading facilities (MTFs); ... all financial derivatives that concern public finances in the EU (including sovereign debt of Member States and local administration balance sheets) must be standardised and traded on exchange or other regulated trading platforms in order to promote transparency of derivatives markets for the public".

32 CESR Technical Advice to the European Commission in the Context of the MiFID Review - Standardisation and Organised Platform Trading of OTC Derivatives (CESR/10-1096)

33 With the introduction of a new title on derivatives

34 To be defined in Article 4 of Directive 2004/39/EC, see section 2.2.1 above

35 To be included in Chapters I and II of Title II of Directive 2004/39/EC

36 COM(2010) 484

clearing eligible and sufficiently liquid derivatives should trade exclusively on regulated markets, MTFs, or organised trading facilities satisfying the conditions above? Please explain the reasons for your views.

- (9) **Are the above conditions for an organised trading facility appropriate? Please explain the reasons for your views.**
- (10) **Which criteria could determine whether a derivative is sufficiently liquid to be required to be traded on such systems? Please explain the reasons for your views.**
- (11) **Which market features could additionally be taken into account in order to achieve benefits in terms of better transparency, competition, market oversight, and price formation? Please be specific whether this could consider for instance, a high rate of concentration of dealers in a specific financial instruments, a clear need from buy-side institutions for further transparency, or on demonstrable obstacles to effective oversight in a derivative trading OTC, etc.**
- (12) **Are there existing OTC derivatives that could be required to be traded on regulated markets, MTFs or organised trading facilities? If yes, please justify. Are there some OTC derivatives for which mandatory trading on a regulated market, MTF, or organised trading facility would be seriously damaging to investors or market participants? Please explain the reasons for your views.**

2.3. Automated trading and related issues

Automated trading also known as algorithmic trading can be defined as the use of computer programmes to enter trading orders where the computer algorithm decides on aspects of execution of the order such as the timing, quantity and price of the order. This form of trading is used by an increasingly wide range of market users (including for example funds and brokers). A specific type of automated or algorithmic trading is known as high frequency trading (HFT). HFT is typically not a strategy in itself but the use of very sophisticated technology to implement traditional trading strategies.³⁷ Existing evidence is inconclusive about the impact of HFT on market efficiency. Some studies suggest that HFT using market making and arbitrage strategies has added liquidity to the market, reduced spreads and helped align prices across markets.³⁸ However, the average transaction size has decreased considerably and some participants question the value of the additional liquidity provided. They argue there may be improved liquidity for investors who trade retail-size orders but it is now more difficult for institutional investors to execute large orders. Also, there are different views about whether HFT increases or reduces market volatility.

37 Although there is debate about how it could be defined, it is perhaps best defined as trading that uses sophisticated technology to try to interpret signals from the market and, in response, executes high volume, automated trading strategies, usually either quasi market making or arbitraging, within very short time horizons. It usually involves execution of trades as principal (rather than for a client) and involves positions being closed out at the end of the day.

38 In its Technical advice to the European Commission in the context of the MIFID review (dated 29 July 2010), CESR estimates that between 13 to 40% of total share trading was from HFT.

Perhaps the most significant new risk arising from automated trading is the threat it can pose to the orderly functioning of markets in certain circumstances. Such threats can arise from rogue algorithms, from algorithms overreacting to market events or from the increased pressure on trading venue systems to cope with the large numbers of orders generated by automated trading.³⁹ These risks can arise whether the automated trader has direct access to the market or uses the facilities of another firm to access the market (sometimes referred to as 'sponsored access').⁴⁰

For HFT there are concerns that not all high frequency traders are currently required to be authorised under MiFID as the exemption in Article 2.1(d) of the framework directive for persons who are only dealing on own account can be used by such traders. Therefore there is a concern that even if a HFT trader is involved in a significant amount of trading they may not necessarily be subject to MiFID requirements and to supervision by a competent authority.

Some market participants have also raised concerns that they are at a disadvantage to HFT as they are not able to make a similar investment in trading technology. Such participants argue they are at a disadvantage as HFT can execute orders and hit liquidity ahead of them.

While HFT may be increasingly providing liquidity to the market in the place of more traditional market making activities, some investors suggested that unlike registered market makers on trading venues there is no obligation or incentive for high frequency traders to continue to provide liquidity to the market in the event of adverse market conditions. Therefore, they are able to withdraw liquidity at any time.

There have also been concerns raised by some market participants that some specific algorithmic trading strategies may be contrary to the Market Abuse Directive (MAD)⁴¹. If practices are contrary to the MAD then action should already be taken by competent authorities under that directive as the prohibitions are broadly drafted to cover all forms of trading. Nonetheless the Commission services consider that further improvements could be introduced in this directive, notably by better defining conduct or practices by means of automated trading that may constitute market abuse.

The Commission services consider that the framework directive could be amended as follows:

- a) Automated trading would be defined⁴² in a broad manner. Automated trading would be defined 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. High frequency trading would be considered a subcategory of automated trading;

39 The 6 May 2010 "flash crash" is a possible case in point although the specific trigger of events appears not to relate directly to HFT.

40 IOSCO released in August 2010 its final report on "Principles for Direct Electronic Access to Markets" under which it recommends that "neither the market nor an intermediary should offer Direct Electronic Access (DEA) unless adequate pre-trade information is provided, and both regulatory and financial controls, including automated pre-trade controls, are in place to enable intermediaries to implement appropriate risk limits."

41 While the majority of algorithmic trading strategies do not involve abusive behaviour, specific strategies (such as layering and spoofing) could breach the Market Abuse Directive and have been subject to guidance issued by supervisors.

42 In Article 4 of Directive 2004/39/EC

- b) All persons involved in high frequency trading over a specified minimum quantitative threshold would be authorised as investment firms.⁴³ This would ensure that they are subject to organisational requirements (such as systems and risk management obligations and capital requirements) and to full regulatory oversight;
- c) A series of new specific organisational requirements⁴⁴ would be introduced with the possibility of further specification in implementing acts on each of the issues below:
- authorised firms involved in automated trading would have in place robust risk controls to mitigate potential trading system errors;
 - firms involved in automated trading would notify their competent authority of the computer algorithm(s) they employ, including an explanation of its design, purpose and functioning;
 - firms who provide "sponsored access" to automated traders would have in place robust risk controls and filters to detect errors or attempts to misuse facilities;
 - operators of trading venues would have in place proper risk controls and arrangements to mitigate the risk of errors generated by automated trading leading to disorderly trading (e.g. circuit breakers) or the breakdown of their trading systems (e.g. by stress testing to ensure resilience);
 - operators of trading venues would give equal and fair access to market participants to co-location services.
- d) Implementing measures could further specify minimum tick sizes;⁴⁵
- e) Market operators would be required to ensure⁴⁶ that if a high frequency trader executes significant numbers 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; and
- f) Market operators would be required to ensure⁴⁷ that orders would rest on an order book for a minimum period before being cancelled. Alternatively they would be required to ensure that the ratio of orders to transactions executed by any given participant would not exceed a specified level. In either case, further specification would be needed on the specific period or level.

(13) Is the definition of automated and high frequency trading provided above appropriate?

(14) What is your opinion of the suggestion that all high frequency

43 In Article 5 of Directive 2004/39/EC

44 In Articles 13, 14 and 39 of Directive 2004/39/EC and relevant new provisions applicable to organised trading facilities

45 These would need to apply to all trading, not just automated trading

46 In Articles 14 and 39 of Directive 2004/39/EC and relevant new provisions applicable to organised trading facilities

47 In Articles 14 and 39 of Directive 2004/39/EC and relevant new provisions applicable to organised trading facilities

traders over a specified minimum quantitative threshold would be required to be authorised?

- (15) **What is your opinion of the suggestions to require specific risk controls to be put in place by firms engaged in automated trading or by firms who allow their systems to be used by other traders?**
- (16) **What is your opinion of the suggestion for risk controls (such as circuit breakers) to be put in place by trading venues?**
- (17) **What is your opinion about co-location facilities needing to be offered on a non-discriminatory basis?**
- (18) **Is it necessary that minimum tick sizes are prescribed? Please explain why.**
- (19) **What is your opinion of the suggestion that high frequency traders might be required to provide liquidity on an ongoing basis where they actively trade in a financial instrument under similar conditions as apply to market makers? Under what conditions should this be required?**
- (20) **What is your opinion about requiring orders to rest on the order book for a minimum period of time? How should the minimum period be prescribed? What is your opinion of the alternative, namely of introducing requirements to limit the ratio of orders to transactions executed by any given participant? What would be the impact on market efficiency of such a requirement?**

2.4. Systematic internalisers

MiFID introduced specific provisions for systematic internalisation.⁴⁸ The core requirement for systematic internalisers (SIs) is to publish firm quotes in shares admitted to trading on a regulated market that are classified as 'liquid' under MiFID when dealing in sizes up to standard market size.

To date only 10 investment firms have been registered as systematic internalisers. The low number of SIs may be attributable to a number of possible factors such as lack of clarity in the definition of a systematic internalisers⁴⁹ and the relative inflexibility of the quote publication regime.

The Commission services consider appropriate to:

- a) Provide more objective criteria in the implementing regulation for determining when a firm is a SI, in particular, by replacing the material commercial relevance test with clear quantitative thresholds and clarify the application in substance of the non-discretionary rules and procedures.

48 The obligations of systematic internalisers to publish firm quotes are specified in Article 27 of Directive 2004/39/EC, while more detailed requirements, including trade transparency, are laid out in Article 21 to 34 of Regulation 1287/2006.

49 Systematic internaliser is defined in Article 4(1)(7) of Directive 2004/39/EC, while Article 21 of Regulation 1287/2006 further specifies criteria for determining whether an investment firm is a systematic internaliser.

- b) Clarify that once the conditions are fulfilled, SI are obliged to register towards competent authorities.
- c) Require SI's to maintain quotes to both buy and sell.
- d) Require SIs to maintain a minimum quote size equivalent to 10% of the standard market size of any liquid share in which they are a SI.
- e) Require SIs who make use of the exemption from identifying themselves in post-trade reports to publish trading data monthly instead of quarterly as a condition of using this exemption.

A further issue relevant to which activities fall within the systematic internaliser definition is how the execution of orders by the use of matched principal trades would be treated for the purposes of MiFID (see paragraph 7.2.8).

- (21) **What is your opinion about clarifying the criteria for determining when a firm is a SI? If you are in favour of quantitative thresholds, how could these be articulated? Please explain the reasons for your views.**
- (22) **What is your opinion about requiring SIs to publish two sided quotes and about establishing a minimum quote size? Please explain the reasons for your views.**

2.5. Further alignment and reinforcement of organisational and market surveillance requirements for MTFs and regulated markets as well as organised trading facilities

Under MiFID the two types of multilateral trading venues (i.e. regulated markets and MTFs) have to comply with similar requirements in terms of organisational arrangements and market surveillance.⁵⁰ Differences mainly reflect areas where MTF markets tend to differ in their nature from traditional markets (e.g. many MTFs trade very specialised instruments or only provide a secondary market in the instruments they trade). It should also be noted that operators of regulated markets have used the flexibility offered by MiFID to set up a variety of different types of MTFs in conjunction with their regulated markets.⁵¹

Nonetheless, two main concerns have been expressed in relation to a lack of alignment of the organisational and also the market surveillance requirements for these two types of trading venues. First, differences in the details of organisational requirements in MiFID that apply to MTFs and regulated markets may lead, in practice, to a lighter regime for the former. This is considered especially problematic where the nature and scale of the competing business models are similar. Second, existing obligations for operators of regulated markets and MTFs to monitor trades conducted on their venues to identify

50 The organisational requirements for regulated markets are set out in Article 39 of Directive 2004/39/EC, while the corresponding requirements for MTFs are provided in Article 14 of Directive 2004/39/EC. The requirements for MTFs and regulated markets to monitor for disorderly conduct or conduct that may involve market abuse can be found in Articles 26 and 43 respectively of Directive 2004/39/EC.

51 These can be either intended as markets for SMEs or as competitors for pan-European trading.

breaches of rules, disorderly trading and market abuse, should be better coordinated, bearing in mind that a financial instrument can be traded on a number of different platforms. While the role of monitoring for market abuse is undertaken by competent authorities and MiFID already provides a mechanism for the exchange of information between supervisors where trading occurs on different venues,⁵² market operators also perform an important surveillance function in detecting possible abuses.

In this context, the Commission services consider appropriate to:

- a) Further align organisational requirements for MTFs with those for regulated markets so that regulated markets and MTFs operating similar businesses of a similar size are subject to equivalent organisational standards and regulatory oversight. Specifically, the Commission services consider that in addition to the organisational requirements in Article 13 of MiFID, MTF operators could also be required to have in place more specific arrangements to identify and manage conflicts of interest, arrangements and systems to identify and mitigate risks to its operations and arrangements for the sound management of the technical operations of the system (including effective contingency arrangements to deal with risks of system disruptions).
- b) Strengthen market surveillance by requiring operators of regulated markets, MTFs and organised trading facilities outlined Section 2.2 above which trade the same financial instruments to cooperate and exchange information in order to better detect market abuse or misconduct that takes place across different venues.⁵³ This would require such venues to immediately inform one another (in addition to their competent authority) of a decision to suspend or remove a financial instrument from trading, of a system disruption including the triggering of a circuit breaker, and of disorderly trading conditions or conduct that may involve market abuse. The venues in receipt of the information would need to reply, also informing their competent authority, of any precautionary measures they propose to take, including a justification if no measures are foreseen.⁵⁴

(23) What is your opinion of the suggestions to further align organisational requirements for regulated markets and MTFs? Please explain the reasons for your views.

(24) What is your opinion of the suggestion to require regulated markets, MTFs and organised trading facilities trading the same financial instruments to cooperate in an immediate manner on market surveillance, including informing one another on trade disruptions, suspensions and conduct involving market abuse?

2.6. SME markets

Small and medium sized enterprises (SMEs) across Europe significantly contribute to economic growth, employment, innovation and social integration. A number of recent

52 Namely the Transaction Reporting Exchange Mechanism (TREM) set up by CESR

53 Amending Articles 26 and 43 of Directive 2004/39/EC

54 New implementing measures could specify the timeframe and precise information requirements.

initiatives have considered the need to assist SMEs in obtaining financing. Two main sources of funding for such companies are private financing by banks or other institutions or raising finance through capital markets (e.g. the issue of shares). SMEs often face a higher cost of capital than larger enterprises. SME markets⁵⁵ aim at providing smaller, growing companies with a platform to raise capital both through initial offerings and ongoing fund raisings. Currently SME markets mostly fall within the MTF regime under MiFID. SME markets aim at providing smaller, growing companies with a platform to raise capital both through initial offering and ongoing fund raising.

In order to promote SME markets, the Commission services consider that regulated markets and MTF could be given the possibility of creating a specialised SME market. For doing that, the framework directive could be amended to include a new definition of an "SME market"⁵⁶ and to introduce specific harmonised requirements for SME markets under the provisions on regulated markets⁵⁷ and MTFs⁵⁸. The regime would set out requirements that are proportionate and tailored to take into account the specific nature and needs of these markets. The definition of an "SME market" could be based on specific criteria concerning the companies that could be listed, such as thresholds (e.g. using the definition of SME of the Prospectus Directive⁵⁹) and market capitalisation (e.g. companies for which the market capitalisation is less than 35% of the average market capitalisation on the trading venues of the Home Member State of the issuer⁶⁰). The main features of the requirements applied to SME markets would be provided for in the framework directive. The regime could include:

- a) Further detail about the organisational and systems requirements applying to the operator of the SME market;
- b) Eligibility conditions for issuers to be traded on the SME market such as which companies qualify as an SME, that key persons in the SME should be fit and proper and relating to the legal nature of the SME and transferability of its shares;
- c) The need for an admission document adapted to take into account the special nature of the issuers on the market;
- d) The need for an audited annual report for SMEs on the market;
- e) The monitoring of trading on the market by the market operator to ensure fair and orderly trading and to detect market abuse such as insider dealing and market manipulation;
- f) Requirements for the settlement of transactions on the market;

55 There are currently at least 17 specialist markets for SMEs that operate across Europe.

56 Article 4(1) of Directive 2004/39/EC

57 Articles 40, 42 and 43 of Directive 2004/39/EC, Articles 35 and 37 of Commission Regulation 1287/2006

58 Articles 13 and 14 of Directive 2004/39/EC

59 Directive 2003/71/EC of the European Parliament and the Council on the prospectus to be published when securities are offered to the public or admitted to trading (OJ L 345 of 31.12.2003) as amended in Article 2(1)(f) "small and medium-sized enterprises" means companies, which, according to their last annual or consolidated accounts, meet at least two of the following three criteria: an average number of employees during the financial year of less than 250, a total balance sheet not exceeding EUR 43,000,000 and an annual net turnover not exceeding EUR 50,000,000.

60 As suggested in the report commissioned by French Minister of Finance, "An EU-listing Small Business Act" by Fabrice Demarigny.

- g) Pre- and post trade transparency requirements for the market;
- h) Oversight of the market operator by its home competent authority.

The aim is that the EU regime, which will give an EU quality label to these markets, provide for more visibility and thus might attract more investors and enhance the possibility of inter-linkages between markets, would impose harmonised requirements that are proportionate and adapted to SME markets and SME issuers while continuing to provide appropriate protection for users of these markets, and investors in SMEs.

(25) What is your opinion of the suggestion to introduce a new definition of SME market and a tailored regime for SME markets under the framework of regulated markets and MTFs? What would be the potential benefits of creating such a regime?

(26) Do you consider that the criteria suggested for differentiating the SME markets (i.e. thresholds, market capitalisation) are adequate and sufficient?

3. PRE- AND POST-TRADE TRANSPARENCY

The key rationale for transparency is to provide investors with access to information about current trading opportunities, to facilitate price formation and assist firms to provide best execution to their clients. It is also intended to address the potential adverse effect of fragmentation of markets and liquidity by providing information that enables users to compare trading opportunities and results across trading venues. Post trade transparency is also used for portfolio valuation purposes. Transparency is crucial for market participants to be able to identify a more accurate market price and to make trading decisions about when and where to trade.

The absence of reliable price information would greatly increase the cost for investors to operate in the market. They would be much less certain about the value of a financial instrument at any given point in time and much less inclined, given the high analytical cost, to undertake transactions in those instruments. As a consequence the number of transactions would be significantly lower, resulting in reduced liquidity and increased indirect transaction costs⁶¹. If, in addition, there would be little or no information available about where to find counterparties with the opposite trading interest, the lack of transparency would result in significant search costs. It would be much more difficult for market participants to search across different venues and obtain the best result for themselves or their client.

Pre- and post trade transparency serves to address these issues. The transparency regime in MiFID only applies to shares admitted to trading on regulated markets (including when those shares are traded on a MTF or over the counter). It was designed to harmonise the available information, mitigate the potential effects of fragmentation of

61 Direct transaction costs refer to the fees paid to, for instance, a trading venue for executing an order. Indirect transaction costs refer to bid/offer spreads, potential market impact and other costs related to executing an order.

market liquidity, integrate EU equity markets in the eyes of issuers and investors, increase the potential number of active market participants in a security, and thus increase liquidity.

3.1. Equity markets

3.1.1. Pre-trade transparency

Pre-trade transparency refers to the obligation to publish (in real-time) current orders and quotes (i.e. prices and amounts for selling and buying interest) relating to shares.⁶² Pre-trade transparency obligations apply to regulated markets, MTFs and systematic internalisers.

Individual market participants would sometimes prefer not to disclose their own trading interest, while having full access to the trading intentions of everybody else. In that context the growth of electronic trading has facilitated the generation of dark liquidity and the use of dark orders⁶³ which market participants apply to minimise market impact costs. An increased use of dark pools does however raise regulatory concerns as it may ultimately affect the quality of the price discovery mechanism on the "lit" markets. Therefore, the issue of dark liquidity merits ongoing observation by regulators and clear boundaries.

The current regime tries to balance the interest of the wider market with the interest of individuals by allowing for waivers from transparency in specific circumstances.^{64 65} For example, the large in scale waiver was designed to accommodate the need of wholesale market participants to be able to execute large orders without too large a price impact. This waiver is essential in striking the right balance between market transparency and protecting legitimate interests of market participants who are essential contributors to the liquidity of markets.

Therefore, the reasons for allowing waivers from pre-trade transparency in the various circumstances described in the current framework still appear valid. However, the

62 Article 27, 29 and 44 of Directive 2004/39/EC provides for the general obligation of systematic internalisers, MTFs and regulated markets to make pre-trade transparency data available. Article 29 and 44 of Directive 2004/39/EC make reference to 'the size or type of orders' and 'the market model for which pre-trade disclosure may be waived', in particular transactions that are concluded 'by reference to prices established outside the systems' of the regulated market or MTF and "transactions that are large in scale". The waivers for pre-trade transparency are further defined in Article 18 and 20 of Regulation 1287/2006.

63 A dark order can be defined as an electronic order that can be automatically executed and for which there is no pre-trade transparency, cf. IOSCO Consultation Report, "Issues Raised by Dark Liquidity", October 2010, p. 4.

64 Although these waivers are each different, they all reflect the aim of providing some flexibility to market participants without jeopardising overall transparency. The waiver for an order which is large in scale is to mitigate potential market impact if the whole order would be disclosed. Other waivers are generally meant to accommodate orders which would not contribute to price formation or could even result in misleading information. The order management facility waiver mimics what an investor might otherwise do manually in order to manage his orders.

65 According to data from the Committee of European Securities Regulators (CESR), of all the trading in shares in the EEA occurring on trading venues more than 90% is pre trade transparent (with less than 10% taking place under the use of waivers). The data shows that the amount of trades using waivers has only slowly increased in recent years. See CESR Technical advice to the European Commission in the context of the MiFID review and Responses to the European Commission Request for Additional Information, 29 July 2010, CESR/10-802, page 7 para. 12.

Commission services see room for improvement as to the calibration, actual content and consistent application of the waivers in the future in order to ensure the right balance and to avoid negative spillovers beyond their intended scope of application. The regulatory aim would be to adjust the framework in order to enhance legal certainty and clarity for supervisors and market participants alike. The waiver regime should be applied consistently across the EU.

The Commission services consider some changes to the framework directive to be required⁶⁶ to ensure the waivers are applied consistently and coherently and to give ESMA a role in monitoring their use. The Commission services suggest that:

- a) Implementing acts could be proposed on the specific methods for the application of the waiver rules in order to ensure legal certainty regarding their interpretation;
- b) ESMA could also be required in the framework directive to monitor the waivers on an ongoing basis and to report annually to the Commission about their use;
- c) Competent authorities of Member States could be obliged to notify ESMA and other competent authorities of the intended use of waivers and provide an explanation regarding their functioning.⁶⁷ ESMA could then be required to publish an opinion about whether the use of the waiver is consistent with MiFID. If a competent authority proposed to allow the use of the waiver contrary to an ESMA opinion it would be required to publicly justify its reasons for doing so;
- d) An actionable indication of interest (i.e. an indication of interest that includes all necessary information to agree on a trade) would be treated as an order and subject to applicable pre-trade transparency requirements and such indication of interest could not be made transparent to direct participants in a trading system without also being made public.

Furthermore, the Commission will need to later supplement these changes with a number of amendments to the implementing regulation in order to clarify the practical implementation of these exemptions.

- a) It could be clarified⁶⁸ that remaining unexecuted parts of initially large in scale orders ("stubs") which do not meet the thresholds anymore could not remain dark;
- b) It could be also clarified⁶⁹ that trades executed under the reference price waiver would be executed at the gross price and would not incorporate any embedded fee in the price; an appropriate minimum order size for the reference price waiver would also be specified.

In the absence of conclusive evidence of the effects of the current thresholds for the large-in-scale waiver, the Commission services consider that these could be retained. While the current thresholds may appear to be inconsistent with the decreasing average sizes of transactions that actually take place on transparent order books, it is not evident that they are resulting in higher execution costs, further market fragmentation, or

66 To articles 29(2) and 44(2) of Directive 2004/39/EC

67 Thereby formalising current process under CESR.

68 Article 20 of Regulation 1287/2006

69 Article 18(1)(a) of Regulation 1287/2006

significant difficulties to execute large orders.⁷⁰ In this context, decreasing the thresholds could have undesired effects in terms of encouraging trading outside lit markets.

- (27) **What is your opinion of the suggested changes to the framework directive to ensure that waivers are applied more consistently?**
- (28) **What is your opinion about providing that actionable indications of interest would be treated as orders and required to be pre-trade transparent? Please explain the reasons for your views.**
- (29) **What is your opinion about the treatment of order stubs? Should they not benefit from the large in scale waiver? Please explain the reasons for your views.**
- (30) **What is your opinion about prohibiting embedding of fees in prices in the price reference waiver? What is your opinion about subjecting the use of the waiver to a minimum order size? If so, please explain why and how the size should be calculated.**
- (31) **What is your opinion about keeping the large in scale waiver thresholds in their current format? Please explain the reasons for your views.**

3.1.2. *Post trade transparency*

Post trade transparency refers to the obligation to publish a trade report every time a transaction in a share has been concluded.⁷¹ This obligation applies to regulated markets, MTFs and investment firms and to trades whether executed on or outside a trading venue. This information differs from pre-trade transparency data because it gives historical information about share transactions executed (rather than information on trading opportunities).

Post trade transparency is important for efficient price formation and for best execution to show which venues or firms are providing the best prices. It is also useful to enable clients of firms to monitor whether they are receiving best execution (i.e. whether the order has been executed at a reasonable price and on an appropriate venue) and is used for the pricing of portfolios.

Market participants require information about trading activity that is reliable, timely and available at a reasonable cost. Market participants have expressed concerns related to the timing of publication. Publication of trade reports must generally take place in real-time, and in any case within 3 minutes, but for large transactions delays between 60 minutes and up to 4 trading days are allowed, depending on the liquidity of the share and the size of the transaction.⁷² Many supervisors as well as market participants seem to agree that

70 See CESR Technical advice to the European Commission in the context of the MiFID review and Responses to the European Commission Request for Additional Information, 29 July 2010, CESR/10-802, page 10 para. 26.

71 Article 28, 30 and 45 of Directive 2004/39/EC provides for the general obligation of investment firms (including systematic internalisers), MTFs and regulated markets to make post-trade transparency data available.

72 Publishing a large trade immediately could move the market against the person taking the position and make it more costly to execute large orders. The reasoning for allowing exemptions to the general rule of full and immediate transparency for large orders is similar to that of pre-trade transparency.

the maximum permitted delays should be reduced. This would help to make post trade information available sooner to the market.

For real time publication, the Commission services consider it necessary to:

- a) Strengthen the framework directive requirements⁷³ by specifying that post trade information would be published as close to instantaneously as is technically possible;
- b) In the implementing regulation⁷⁴:
 - Reduce the deadline for reporting in real time from 3 minutes to 1 minute; and
 - Require systems not to be designed to publish details in a "batch" but instead to publish the details as soon as they are entered into the system.

For the deferred publication regime of large transactions, the Commission services consider necessary in the implementing regulation to:⁷⁵

- a) Shorten the delays permitted so that almost all transactions are published no later than the end of the trading day. Only the very largest trades that occur late in the trading day could be able to be published on the next day but even then before the opening of the following trading day;
- b) Shorten the intra-day delay period from 3 hours to 2 hours; and
- c) Raise the intra day transaction size thresholds.

(32) What is your opinion about the suggestions for reducing delays in the publication of trade data? Please explain the reasons for your views.

3.2. Equity-like instruments

The pre and post trade transparency requirements currently only apply to shares admitted to trading on a regulated market. A number of instruments that are similar to shares are outside the scope of MiFID transparency requirements. Given the similarity of the instruments to equities, support from market participants and supervisors and the fact that some Member States already apply transparency requirements to such instruments, the Commission services consider that the framework directive⁷⁶ could be amended to extend the transparency regime to the following equity like financial instruments if admitted to trading on a regulated market:

- a) Depositary receipts;

73 Articles 28 (1), 30 (1) and 45 (1) of the Directive 2004/39/EC

74 Article 29 of Regulation 1287/2006

75 In Table 4, Annex II of Regulation 1287/2006

76 Articles 25, 29, 30, 44 and 45 of Directive 2004/39/EC

- b) Exchange traded funds; and
- c) Certificates issued by companies (i.e. securities issued by a company that rank above ordinary shareholders but below unsecured debt holders for the repayment of the investment).

The regime would in principle 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 concerned. For example, appropriate thresholds for applying the pre-trade large in scale and post trade deferred publication regimes would be developed for each type of financial instrument in the implementing measures.

(33) What is your opinion about extending transparency requirements to depositary receipts, exchange traded funds and certificates issued by companies? Are there any further products (e.g. UCITS) which could be considered? Please explain the reasons for your views.

(34) Can the transparency requirements be articulated along the same system of thresholds used for equities? If not, how could specific thresholds be defined? Can you provide criteria for the definition of these thresholds for each of the categories of instruments mentioned above?

3.3. Trade transparency regime for shares traded only on MTFs or organised trading facilities

The MiFID pre- and post-trade transparency regime applies to shares admitted to trading on a regulated market. The regime covers trading of such shares whether it takes place on a regulated market, on a MTF or OTC. The regime does not apply though if an instrument is only admitted to trading on a MTF or another organised trading facility as outlined in Section 2.2 above. In the former case the higher level transparency obligations for MTFs in the Directive, instead of the more detailed regime⁷⁷, apply to the shares. This leaves a potential difference in the level of transparency for shares that are only admitted to trading on a MTF. In practice the number of such shares is currently limited (e.g. shares on SME markets). But it is possible that in the future with the greater innovation and competition allowed by MiFID, MTFs and organised trading facilities may increasingly admit shares to their venues that are not admitted to trading elsewhere.⁷⁸

The Commission services therefore consider that the framework directive⁷⁹ could be amended to provide that the more detailed transparency regime for shares admitted to trading on a regulated market also applies to shares that are only admitted to trading on a MTF or organised trading facilities. The Commission services consider that such an amendment could be onerous for MTFs or organised trading facilities that operate SME markets and therefore would suggest a calibrated approach for such MTFs or organised trading facilities. This would consist of providing for the principle of a proportionate

⁷⁷ Article 14(1) of the Directive 2004/39/EC

⁷⁸ See also Section 2.1 above

⁷⁹ Articles 25, 29, 30, 44 and 45 of Directive 2004/39/EC

regime for these MTFs or organised trading facilities in the framework directive, whereas specific details could be further developed in implementing legislation.

(35) What is your opinion about reinforcing and harmonising the trade transparency requirements for shares traded only on MTFs or organised trading facilities? Please explain the reasons for your views.

(36) What is your opinion about introducing a calibrated approach for SME markets? What should be the specific conditions attached to SME markets?

3.4. Non equity markets

Existing price and market data reporting tools for non-equities are not always considered sufficient. Prices in several non-equity OTC markets are a function of the willingness of dealers to provide investors with quotes on request through electronic or manual (telephone) channels and enter into trades with them; not a public interaction of supply and demand. The balance between transparency and liquidity in non-equities (as in equities) is hotly debated, with many arguing that too much transparency has a detrimental effect on liquidity.

Improvements could therefore aim to help the market deal with inherent information asymmetries, support fair and orderly pricing, and improve overall market efficiency and resilience. The Commission services consider that the principles of the existing MiFID transparency regime for shares could be adopted, but the detailed requirements should be suitably tailored to the specificities of the different non-equity asset classes. However, in order to support consolidation of trade data, publication of post-trade transparency data would, as far as possible, follow the same channels as for equities.⁸⁰

Therefore, the Commission services consider that the MiFID framework directive could be amended to require pre- and post-trade transparency for all trades in specific non-equity products, whether executed on regulated markets, MTFs, organised trading facilities or OTC. These new requirements would be differentiated by asset class. The new transparency regime would be achieved through the setting up of new obligations for investment firms, whether trading OTC or within organised trading facilities, as well as for MTFs and regulated markets.^{81 82}

This requirement would apply to:

- a) All bonds and structured products with a prospectus or which are admitted to trading either on a regulated market or MTF; and
- b) All derivatives eligible for central clearing according to Article 4 and all derivatives reported to trade repositories according to Article 6(1) of the

⁸⁰ See section 4 below.

⁸¹ This would require amendments to, or new articles alongside, articles 27, 28, 29, 30, 44 and 45 of the Directive 2004/39/EC as well as corresponding provisions for any new categories of venues (see section 2.2 above).

⁸² See also CESR Technical Advice to the European Commission in the Context of the MiFID Review: Non-equity Markets Transparency, 29 July 2010, CESR/10-799

Commission proposal on OTC derivatives, central counterparties and trade repositories.⁸³

These instruments are considered to be the more liquid and more frequently traded market segments per asset class.

3.4.1. Pre-trade transparency

In terms of overarching requirements, the framework directive would specify that all regulated markets, MTFs, and organised trading facilities as per section 2.2.3 above offering trading in the above non-equity instruments would publish their pre-trade information in a continuous manner. As for investment firms executing trades OTC, the framework directive would require that their pre-trade quotes reflect current market value and are binding below a specific trade size. Similarly to the systematic internaliser regime, this would however not mean an obligation to quote on a constant basis for every product. This would only mean that an investment firm which is willing and interested to quote or receiving a request to quote on a specific product which it agrees to meet, would be required to make its quote both in terms of price and volume available to the public, and commit to it below the specified size.

The Commission services consider that the implementing measures for pre-trade requirements applicable to regulated markets, MTFs, and organised trading facilities as per section 2.2.3 above would provide for a real-time and continuous updating of available and actionable trading interest. Depending on the nature of the system and asset class, these would specify the range and depth of binding commitments to buy and sell the instruments above. As for implementing measures outlining quoting requirements for investment firms acting OTC, the Commission services consider that these would specify that quoted prices could not significantly deviate from pre-trade information available for comparable or identical instruments on regulated markets, MTFs or organised trading facilities as per section 2.2.3 above, as well as specify the size-threshold per asset-class under which quotes would be binding. This could represent a commonly accepted value of trades in each asset-class beneath which the risk associated with the trade can easily be laid off in the market, and is likely to be undertaken by or on behalf of retail investors.

3.4.2. Post-trade transparency

The Commission services consider that the framework directive would specify that the timing and content of post-trade information to be published for the instruments above by investment firms acting OTC and all organised trading venues, including regulated markets, MTFs and any organised trading facilities as per section 2.2 above, would be as prompt and precise as possible.

As non equity products are very different one from another, the Commission services consider that the exact post-trade transparency regime would need to be defined for each asset class and in some cases for each type of instrument within this asset class. The

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Commission services consider that new provisions in the implementing regulation⁸⁴ for post-trade transparency could be articulated around the following:⁸⁵

- a) In order to minimise information asymmetries and improve pricing, the post-trade transparency regime would be transaction-based. It would provide data on transactions in terms of price, volume, time of trade, and the main reference characteristics of the traded instrument rather than aggregate data;
- b) The transparency regime would be properly calibrated to the class of financial instruments (bond, structured finance product, derivative) and to the type of instrument (option, swap, forward) as well as underlying variable, for instance a financial asset or a commodity, as appropriate;
- c) The transparency regime would be predicated on a system of thresholds and delays, based on transaction size;

(37) What is your opinion on the suggested modification to the MiFID framework directive in terms of scope of instruments and content of overarching transparency requirements? Please explain the reasons for your views.

(38) What is your opinion about the precise pre-trade information that regulated markets, MTFs and organised trading facilities as per section 2.2.3 above would have to publish on non-equity instruments traded on their system? Please be specific in terms of asset-class and nature of the trading system (e.g. order or quote driven).

(39) What is your opinion about applying requirements to investment firms executing trades OTC to ensure that their quotes are accessible to a large number of investors, reflect a price which is not too far from market value for comparable or identical instrument traded on organised venues, and are binding below a certain transaction size? Please indicate what transaction size would be appropriate for the various asset classes.

(40) In view of calibrating the exact post-trade transparency obligations for each asset class and type, what is your opinion of the suggested parameters, namely that the regime be transaction-based, and predicated on a set of thresholds by transaction size? Please explain the reasons for your views.

(41) What is your opinion about factoring in another measure besides transaction size to account for liquidity? What is your opinion about whether a specific additional factor (e.g. issuance size, frequency of trading) could be considered for determining when the regime or a threshold applies? Please justify.

3.5. Over the counter trading

The Commission services consider that (notwithstanding section 2.2.3 above concerning derivatives) the MiFID could continue to be neutral as to where a trade is executed.

84 Amending and/or complementing Sections 2 and 3 of Chapter IV of Regulation 1287/2006

85 See also CESR Technical Advice to the European Commission in the Context of the MiFID Review: Non-equity Markets Transparency, 29 July 2010, CESR/10-799

Nonetheless, concerns have been raised by some market participants over the lack of granular information about the nature and extent of trading that is taking place in various instruments outside regulated markets, MTFs and systematic internalisers. Such OTC trading is currently subject to the full range of MiFID organisational (e.g. conflicts of interest) and conduct of business requirements and subject to post-trade and transaction reporting requirements.

Regulators from some Member States have suggested that there could be greater granularity of information about such trading. The Commission services consider that as well as requiring further post trade identification of trades on organised trading facilities (referred to in the requirements in section 2.2.1), there could be identification and flagging of trades that are OTC in post trade transparency reports.⁸⁶ This would ensure that there is much more granular and accurate information about levels of OTC trading.

**(42) Could further identification and flagging of OTC trades be useful?
Please explain the reasons.**

4. DATA CONSOLIDATION

Besides requiring market data to be reliable, timely and available at a reasonable cost, investors also require the information to be brought together in a way that allows comparison of prices across different venues. Experience since the implementation of MiFID shows that the reporting and publication of trade data in shares is not living up to this expectation.⁸⁷ The main problems relate to the quality and format of the information, as well as the cost charged for the information and the difficulty in consolidating the information. If these issues are not fully addressed, they could undermine the overarching objectives of MiFID as regards transparency, competition and investor protection. While a number of initiatives have been put in place to try to address these issues there are practical and commercial obstacles that appear to necessitate regulatory intervention to improve post trade information and facilitate consolidation.

Data consolidation is primarily considered to be a challenge in equity markets. Nonetheless, as stated in section 3.4 above, since post-trade transparency requirements are being considered for non-equity instruments, the Commission services consider that the provisions below could apply also to non-equity markets, subject to specific adaptations if necessary.

The suggestions of the Commission services in this area can be grouped under a number of different headings:

- a) Improving the quality and consistency of raw trade data and ensuring it is provided in a consistent format (to facilitate consolidation);

⁸⁶ In Article 28 of Directive 2004/39/EC and any relevant new Articles referred to in footnote 68 above.

⁸⁷ Prior to MiFID trade data would typically be available from the incumbent exchange in each Member State. OTC trades were sometimes not reported at all. MiFID has required post-trade reporting of OTC trades and spurred competition among trading and reporting venues. This has made the trade data environment more complex and made proper trade data consolidation more important.

- b) Reducing the cost of post-trade data for investors; and
- c) Introducing a consolidated tape for the EU market.

4.1. Improving the quality of raw data and ensuring it is provided in a consistent format

CESR has identified concerns about quality and consistency of the raw data in post trade reports and the lack of consistency in the formatting of data (which makes it difficult to later consolidate the data across markets).⁸⁸ It has also expressed concerns about the lack of any legal requirements to publish data through bodies with responsibilities relating to data monitoring and publication. There is also a lack of clarity about which investment firm is responsible for reporting over the counter transactions and how transactions are reported where there are a series of transactions that are in effect a single trade. This has led to significant double reporting and counting of trades, especially OTC trades. Finally concerns have been raised that in isolated cases trades may have been reported in locations far away from where they took place to avoid market and regulatory scrutiny.⁸⁹

While MiFID provides details on the general requirements that need to be met for post trade transparency, the Commission services consider that the framework directive could be amended⁹⁰ to require all firms who execute transactions to publish their trade reports through an Approved Publication Arrangement (APA).⁹¹

The following conditions could be set:

- a) An APA could be a regulated market, a MTF, an organised trading facility or another organisation (such as a data vendor or a trade repository in the case of derivatives, subject to it being able to meet the necessary requirements notably in terms of timing);
- b) An APA would be authorised by the competent authority of the Member State where it is based and subject to on-going supervision of the competent authority. This authorisation would be valid throughout the EU;
- c) An APA would assist in improving the quality and format of information in trade reports. It would also help prevent situations where an investment firm reports a trade in a location or via a method seeking to avoid scrutiny. For that purpose it would need to meet specific criteria, notably:
 - Guarantee a high level of data security;

88 See CESR Technical advice to the European Commission in the context of the MiFID review and Responses to the European Commission Request for Additional Information, 29 July 2010

89 There have been isolated cases of trades being reported in unexpected locations seemingly to avoid scrutiny.

90 In Articles 28, 35 and 40 of Directive 2004/39/EC and any new post-trade transparency provisions applicable to non-equities

91 With this approach, competent authorities would approve entities wishing to act as an APA, and APAs would be required to operate data publication arrangements to prescribed standards.

- Demonstrate that they can efficiently and consistently disseminate trade data in a way that ensures fast access to the data on a non-discriminatory basis at a reasonable cost;
- Effectively identify erroneous trade reports by undertaking appropriate checks to ensure that relevant fields are completed in trade reports and obvious errors are identified;
- Maintain adequate resources and contingency arrangements; and
- Manage conflicts of interest appropriately and submit regular and timely reports to the relevant competent authority.

In order to improve the quality and interoperability of raw data at the source and further ease the process with which data can be consolidated, the Commission services consider that the implementing regulation could be amended to supplement existing provisions and provide much more detail and clarity about both the content⁹² and format of trade reports. This would address the current problems caused by trading venues and firms not standardising the content and format of information reported to the market (which in turn creates a significant obstacle to consolidation). This would ensure information is clearer, more comparable and can be more easily consolidated. Also, it would be necessary to clarify in the implementing regulation which investment firm would report information about over the counter transactions and how transactions would be reported where a series of transactions are in effect a single economic trade.⁹³

- (43) What is your opinion of the suggestions regarding reporting to be through approved publication arrangements (APAs)? Please explain the reasons for your views.**
- (44) What is your opinion of the criteria identified for an APA to be approved by competent authorities? Please explain the reasons for your views.**
- (45) What is your opinion of the suggestions for improving the quality and format of post trade reports? Please explain the reasons for your views.**
- (46) What is your opinion about applying these suggestions to non-equity markets? Please explain the reasons for your views.**

4.2. Reducing the cost of post trade data for investors

The second major issue that has been identified in relation to post trade transparency data is the high cost of the data.⁹⁴ MiFID currently requires that transparency information must be made available to the public on a reasonable commercial basis and in a manner

92 Namely, the tables in annex to Regulation 1287/2006

93 In Article 27 of Regulation 1287/2006

94 Due to the relatively large number of entities publishing trade data and the cost charged by some entities for that data the total cost for constructing a complete real time consolidated tape has been estimated at about €500 per screen per month. In comparison the cost for the similar product in the US is around €70.

which is easily accessible to market participants.⁹⁵ A number of complementary measures to efficiently address the issue are necessary:

(i) Unbundling of data

Trading venues typically sell their pre-trade data and post trade data in the same 'package'. This means that often it is not possible to buy one set of data without buying another. A majority of market participants believe that requiring 'unbundling' of the data, meaning data would be available in more granular form, would contribute to bringing down costs.⁹⁶ The Commission services consider that the framework directive could be amended⁹⁷ to require the selling of unbundled pre- and post-trade data. Further specifications on how far data would need to be disaggregated would be required at a subsequent stage. This requirement would extend to any third party that resells or disseminates the data.

(ii) Data to be made available for free after 15 minutes

Currently some trading venues make their trade data available free of charge 15 to 30 minutes after its initial publication. The Commission services consider that the framework directive⁹⁸ could impose a standard time of 15 minutes after which trade data would be made available for free as this would help reduce costs, in particular for retail clients. Once again, this requirement would also apply to third parties that resell or disseminate the data.

(iii) Defining reasonable cost

The Commission services consider that in addition further detail could be provided about what constitutes a "reasonable" cost for the selling or dissemination of data.

- (47) What is your opinion of the suggestions for reducing the cost of trade data? Please explain the reasons for your views.**
- (48) In your view, how far data would need to be disaggregated? Please explain the reasons for your views.**
- (49) In your view, what would constitute a "reasonable" cost for the selling or dissemination of data? Please provide the rationale/criteria for such a cost.**
- (50) What is your opinion about applying any of these suggestions to non-equity markets? Please explain the reasons for your views.**

95 Articles 28(1), 30(1) and 45(1) of Directive 2004/39/EC

96 The idea is that once the data elements can be bought separately, the pricing power of the individual data source is less strong. In particular data elements that are considered relatively expensive will easily be omitted from the customised data consolidation arrangement for a particular user. Provided that a data source still wishes to sell this particular set of information the price will have to be reduced accordingly. A minority of market participants oppose this idea, arguing either that it is technically difficult/costly or that market participants generally want to buy all the data, leading to no material change in the market for trade data.

97 In Articles 28, 30 and 45 of Directive 2004/39/EC with more detail specified in implementing measures

98 In Articles 28, 30 and 45 of Directive 2004/39/EC with more detail specified in implementing measures.

4.3. A European Consolidated tape

A consolidated tape could be defined as an integrated reporting system regarding the essential characteristics of trades, as described in the framework directive regarding shares,⁹⁹ in instruments in all markets on- and off-exchange wherever they are traded. A mandated tape would provide comprehensive consolidation of post-trade data. It could also offer market users a single point of access to post-trade information about trading of instruments (both on different trading venues and OTC) across Europe.

Hence, the regulatory objectives of such a European consolidated tape could be summed up as follows:

- Consolidate the entire data available in the EU and make it available to the market at a reasonable price;
- Mitigate the effects of a fragmented market structure where a number of instruments are traded on a multitude of trading venues and thereby promote the creation of a single market; and
- Ensure that the trade data is recorded comprehensively and picked-up so that the quality of the data available is improved.

The Commission services, therefore, consider that MiFID could be amended to provide for the establishment of a mandatory consolidated tape and to set the conditions that such a tape should satisfy. This would require amendments to the framework directive itself. The conditions might include, for example:

- a) Requirements relating to the information that must be included in the consolidated tape;
- b) Its format, accessibility, latency and cost; and
- c) The period for which data must be kept.

The precise details would depend upon the model adopted for the consolidated tape. The Commission services submit the following three options for consideration:

Option A

One option would be to mandate that the formal consolidated tape would be operated by a single, non-profit seeking entity, established and appointed by a legal act.

This is similar to the model used in the United States where a separate entity¹⁰⁰ was set up to operate the consolidated tape. In Europe a similar model could be used with either a dedicated entity providing the consolidated tape or an existing public authority or industry body with the necessary expertise operating the consolidated tape. Trading platforms and APAs would have to make their data available to this entity in a prescribed

99 Art. 45 (1) and Art. 30 (1) of Directive 2004/39/EC

100 Consolidated Tape Association (CTA)

format. The single entity would then consolidate the information and make it available to the public in a non-discriminatory fashion on a reasonable cost basis.

In order to be appointed, the single entity would need to demonstrate that it fulfils at least the following conditions:

- Guarantee a high level of data security;
- Demonstrate that it can efficiently and consistently accept, collect and consolidate data supplied by trading venues and APAs and then disseminate trade data in a way that ensures fast access to the data on a non-discriminatory basis at a reasonable cost;
- Maintain adequate contingency arrangements; and
- Manage conflicts of interest appropriately and submit regular and timely reports to the relevant competent authority.

In accordance with the US regime, revenue from the provision of data would be paid to trading platforms and APAs that have provided the data in accordance with a prescribed formula minus the costs incurred by the single entity. Hence, the on-going funding of the single entity would be met by the revenues generated.

Option B

Another option would be to also mandate that the consolidated tape would be operated by a single entity. However, this entity would be a commercial undertaking that is appointed following a public tender upon the merit of its bid submitted to the European Commission.

In order to be appointed, the single entity would need to demonstrate that it fulfils the same conditions as under Option A above.

The mode of operation would be similar to the one described for Option A, ie trading venues and APAs would make their data available to the single entity, the single entity would consolidate the data and then make it available to the public.

As to the revenue side different sub-options can be discussed here:

- One alternative would be for trading venues and APAs to make their data available to the single entity on a reasonable commercial basis. The single entity would then also make the consolidated stream available to the market on a reasonable commercial basis. That way the single entity would be required to constantly optimise its processes and operate as a commercial undertaking in a competitive environment to remain profitable.
- The second alternative would be along the lines of Option A where trading venues and APAs would make the data available to the single entity for free and would then participate in the revenue the single entity would obtain from selling it to the market on a reasonable commercial basis according to a prescribed formula.

In addition, this option would be different from Option A because the appointment of the single entity would be for a limited period of time after which the mandate would be subject to another public tender. This approach may also maintain competitive pressure on the provider of the consolidated tape to constantly review and improve the service it provides to the public or otherwise lose the mandate.

Option C

A variation on Option B would be to prescribe in MiFID conditions that must be met for the provision of a consolidated tape and then allow competing commercial providers to provide the consolidated tape if they meet those conditions. Within a defined timeframe these providers would need to be approved by competent authorities and start to operate.

The framework directive would need to be adapted to contain criteria for approval of the consolidated tape providers. The approval process would encompass similar criteria to the approval of APAs or the conditions applicable to the single entity described under Options A and B.

On the revenue side the consolidated tape providers would be required to acquire the data and make it available to the market as a whole on a reasonable commercial basis.

It is worth noting that at this stage the Commission Services do not envisage proposing the implementation of a consolidated tape for pre-trade transparency data. Given the current structure of EU-markets a consolidated tape on the pre-trade side, while desirable in its own right, does not appear to be paramount as the level of harmonisation of markets in the EU differs substantially from those in the US. Interconnection between different EU markets and the consolidation of quotes is fully possible today but mandating it could give rise to unnecessary costs. As the timeliness of consolidation of pre-trade transparency data would be even more important than on the post-trade side, due to the fact that the data would need to be available instantaneously to be useful for market participants, the current market structure would appear to render a mandatory consolidation of pre-trade information less essential.

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| <p>(51) What is your opinion of the suggestion for the introduction of a European Consolidated Tape for post-trade transparency? Please explain the reasons for your views, including the advantages and disadvantages you see in introducing a consolidated tape.</p> <p>(52) If a post-trade consolidated tape was to be introduced which option (A, B or C) do you consider most appropriate regarding how a consolidated tape should be operated and who should operate it? Please explain the reasons for your view</p> <p>(53) If you prefer option A please outline which entity you believe would be best placed to operate the consolidated tape (e.g. public authority, new entity or an industry body).</p> <p>(54) On Options A and B, what would be the conditions to make sure that such an entity would be commercially viable? In order to make operating a European consolidated tape commercially viable and thus attaining the regulatory goal of improving quality and supply of post-trade data, should</p> |
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market participants be obliged to acquire data from the European single entity as it is the case with the US regime?

- (55) **On Option B, which of the two sub-options discussed for revenue distribution for the data appears more appropriate and would ensure that the single entity described would be commercially viable?**
- (56) **Are there any additional factors that need to be taken into account in deciding who should operate the consolidated tape (e.g. latency, expertise, independence, experience, competition)?**
- (57) **Which timeframe do you envisage as appropriate for establishing a consolidated tape under each of the three options described?**
- (58) **Do you have any views on a consolidated tape for pre-trade transparency data?**
- (59) **What is your opinion about the introduction of a consolidated tape for non-equity trades? Please explain the reasons for your views.**

5. MEASURES SPECIFIC TO COMMODITY DERIVATIVE MARKETS

MiFID applies to all types of commodity derivatives which meet the definition of a financial instrument irrespective of the underlying physical commodity (e.g. agricultural commodities, energy, or emission allowances).¹⁰¹ Recent developments in commodity markets have highlighted a number of challenges. Many commentators have raised concerns that the increased presence of financial investors, especially in some key benchmark commodity derivative markets (e.g. oil and agricultural markets) may lead to excessive price increases and volatility.¹⁰² Others have pointed to more technical problems and price dislocations.¹⁰³ Finally concerns over market integrity have been raised, namely in EU energy and carbon markets.

Amid the uncertainty, the G20 agreed "to improve the regulation, functioning, and transparency of financial and commodity markets to address excessive commodity price volatility." For its part, the Commission, as announced in its Communication of 2 June 2010, is proposing and further considering a comprehensive, balanced and ambitious set of policy initiatives which will touch upon commodity derivatives markets. Among others, this concerns the proposal on OTC derivatives, central counterparties and trade repositories,¹⁰⁴ the proposal on short-selling and certain aspects of credit default swaps,¹⁰⁵ the upcoming review of the Market Abuse Directive, and the ongoing work on

101 Commodity derivatives are financial instruments as provided in of Annex I Section C (5) to (7) and (10) of Directive 2004/39/EC, and Articles 38 and 39 of Regulation No. 1287/2006.

102 For example, the European Parliament, in its resolution above, calls for a ban on "purely speculative trading in commodities".

103 See for example, the "Rapport du groupe de travail sur la volatilité des prix du pétrole sous la présidence de Jean-Marie Chevalier" (February 2010) p.16ff. and the "Rapport d'étape: Prévenir et gérer l'instabilité des marchés agricoles" par Jean-Pierre Jouyet, Christian de Boissieu, and Serge Guillon (September 2010)

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Packaged Retail Investment Products (PRIPs). The review of MiFID is an integral part of this effort.

However, in order to fully match the level of ambition and commitment expressed by the G20,¹⁰⁶ the Commission services consider that a separate chapter in the new title on derivatives in the MiFID framework directive could be added to help ensure that sufficient clarity and regulatory focus are devoted to how commodity derivative markets function in the future.¹⁰⁷ In addition to position reporting obligations by categories of traders active on organised trading venues, regulators could be given complete powers to manage and control positions in commodity derivatives more rigorously.¹⁰⁸

Each commodity market is different, and the magnitude of the challenge varies accordingly. However, the EU regulatory framework applicable to commodity derivative markets would, as far as possible, remain common to all types of commodity derivatives markets while recognising the need for suitable exemptions for non-financial participants.¹⁰⁹

5.1. Specific requirements for commodity derivative exchanges

Commodity derivative contracts traded on organised trading venues are generally the most liquid, with the broadest participation by users and investors, and can serve as a benchmark price setting and discovery function feeding into, for example, energy and food prices for EU users and consumers. Currently, organised commodity derivative trading venues employ a variety of means to monitor positions taken by members of the venue and other traders, and in cooperating with regulators in order to comply with their general duty to preserve fair and orderly markets and detect conduct that may involve market abuse.

In the absence of any position reporting obligation towards regulators in MiFID, the way positions are monitored and the information made available to regulators varies across jurisdictions and organised trading venues. In addition, the granularity of the information available does not readily enable regulators to get a comprehensive and objective picture of the activities of different types of traders (commercial versus financial participants). More systematic, standardised information on positions in relation to these contracts would be helpful, both to regulators (including the category *and* identity of the end-

106 The G20 calls "on relevant regulators to collect data on large concentrations of trader positions on oil in our national commodities futures markets... [and] to also collect related data on over-the-counter oil markets and to take steps to combat market manipulation leading to excessive price volatility. We call for further refinement and improvement of commodity market information, including through the publication of more detailed and disaggregated data, coordinated as far as possible internationally".

107 In follow up to the report of the Task Force on Commodity Futures Markets of the International Organisation of Securities Commissions (IOSCO) of March 2009, this would support efforts by European and global regulators in improving commodity market information and their ability to identify possible harmful practices, including across OTC and physical markets.

108 See Section 9.2 below

109 Cf. the exemptions for commodity firms under Article 2(1)(i) and (k) of Directive 2004/39/EC, and the debate around corporate end-user exemptions from mandatory clearing or higher collateral requirements for some OTC derivatives.

client) and market participants (including only aggregate positions of categories of end-clients).¹¹⁰

The Commission services therefore consider necessary to introduce, in the framework directive, a position reporting obligation by categories of traders for contracts traded on all EU organised trading venues which admit commodity derivatives to trading: regulated markets, MTFs, or organised trading facilities.¹¹¹

Any system of position reporting by categories of traders could be designed to provide meaningful, value-added information to regulators and the public on the activities of different market participants. The following options exist:

- a) Refer to regulatory classifications used in EU financial markets legislation (e.g. investment firms, credit institutions, alternative investment fund managers, UCITS, pension funds, insurance companies) with investment firms and banks required to report on whose behalf they are trading including the regulatory classification (if any) of their end customers. Commercial traders would thus be all traders not listed as specific regulated entities under the EU financial markets legislation.
- b) Rely on the way derivatives are accounted for under international accounting standards, i.e. IFRS IAS 39. Positions would be distinguished by whether the relevant transaction qualifies for hedge accounting or not.
- c) A third option would be a combination of the two preceding ones. The end beneficiary would first be classified by any regulatory regime it is subject to, and secondly the transaction would be labelled as being a hedge or non-hedge transaction, based on the way it is accounted for.

Finally, it has been observed that problems of convergence between futures and spot prices in certain US agricultural derivatives are principally due to deficiencies in the contract specifications drawn up by the exchange. In order to pre-empt the issue emerging in Europe the Commission services consider that a further specification to the MiFID implementing regulation¹¹² could be added requiring regulated markets, MTFs and organised trading facilities to design commodity derivatives contracts which they admit to trade and which can be physically settled in a way that ensures convergence between futures and spot prices.

(60) What is your opinion about requiring organised trading venues which admit commodity derivatives to trading to make available to regulators (in detail) and the public (in aggregate) harmonised position information by type of regulated entity? Please explain the reasons for your views.

(61) What is your opinion about the categorisation of traders by type of

110 As proposed in the Commission Communication on "A Better Functioning Food Supply Chain in Europe", 28 October 2010 – COM(2009) 591 and accompanying Staff Working Document on "Agricultural commodity derivative markets: the way ahead", in which it was recommended that position reporting obligations by categories of traders should be introduced and that the possibility of enabling regulators to set position limits will be assessed.

111 In a specific chapter to the new title on derivatives in Directive 2004/39/EC

112 Article 37(e) of Regulation 1287/2006

regulated entity? Could the different categories of traders be defined in another way (e.g. by trading activity based on the definition of hedge accounting under international accounting standards, other)? Please explain the reasons for your views.

(62) What is your opinion about extending the disclosure of harmonised position information by type of regulated entity to all OTC commodity derivatives? Please explain the reasons for your views.

(63) What is your opinion about requiring organised commodity derivative trading venues to design contracts in a way that ensures convergence between futures and spot prices? What is your opinion about other possible requirements for such venues, including introducing limits to how much prices can vary in given timeframe? Please explain the reasons for your views.

5.2. MiFID exemptions for commodity firms

Broadly speaking, commodity firms may be exempt from MiFID when they deal on own account in financial instruments or provide investment services in commodity derivatives on an ancillary basis as part of their main business and when they are not subsidiaries of financial groups.¹¹³ These exemptions are intended to cover commercial users and producers of commodities, under the assumption that commercial firms and specialist commodity firms do not pose systemic risks comparable to traditional financial institutions nor interact with investors.

It has been suggested that commercial companies benefiting from the MiFID exemptions active in the oil market should not provide investment services in commodity derivatives even as an ancillary activity.¹¹⁴ As these MiFID exempt firms are not subject to any MiFID provisions – including the conduct of business rules – some national regulators and market participants have argued that unsophisticated clients would not be adequately protected. On the other hand, this notion of ancillary activity appears to be an essential provision for agricultural cooperatives, enabling them to provide hedging tools to their farmers while remaining exempt from a regulatory regime ill-calibrated to the small risks they pose to the financial system. Both securities and prudential regulators' point of view is that there is a case for providing a more narrow interpretation of allowed exempt activities in line with the overall purpose of MiFID.¹¹⁵

Therefore, the Commission services consider that these exemptions could be modified as follows:

- a) The framework directive would be amended so that the first part of the exemption in Article 2(1)(i) would exclude dealing on own account with clients of the main business. This would be consistent with the suggestion to modify the exemptions

¹¹³ Article 2(1)(i) and (k) of Directive 2004/39/EC exempts the same firms from the Capital Requirements Directive (CRD) as well.

¹¹⁴ See Rapport du groupe de travail sur la volatilité des prix du pétrole, sous la présidence de Jean Marie Chevalier (February 2010), p.52f.

¹¹⁵ CESR-CEBS Technical Advice to the European Commission on the review of commodities business, 15 October 2008, CESR/08-752.

in Article 2(1)(d) (see section 7.2.8 below) and would more clearly limit the scope of the exemption to apply to the intended business of hedging physical and price risks;

- b) New implementing measures would ensure that the second part of the exemption in Article 2(1)(i) concerning the notion of ancillary activity is applied in a very precise and narrow way. This could rely on quantitative (e.g. revenue from the ancillary activity could not exceed a certain percentage of the main activity) as well as qualitative (e.g. the firm cannot dedicate specific resources or personnel for carrying out the ancillary activity) distinctions;
- c) The exemption in Article 2(1)(k) of the framework directive would be deleted. Recent experience with various commodity firms setting up MiFID-licensed subsidiaries and the political consensus to limit exemptions from financial regulation only to necessary cases, clearly underlines that the former justification for a specific exemption from MiFID for commodity derivative trading houses is no longer valid.

The capital requirements applicable to investment firms whose main business consists exclusively of the provision of investment services or activities in relation to commodity derivatives, including firms potentially affected by restricting the scope of the exemptions from MiFID in this way, will be addressed in a separate review.¹¹⁶

Meanwhile, increased transparency towards regulators in relation to some significant commercial participants, also to help identify the build up of any systemic risk and combating market abuse, would be promoted by requiring exchanges to report the transactions of non-regulated members to regulators¹¹⁷. Also, with respect to OTC trades, the Commission proposal on OTC derivatives, central counterparties and trade repositories,¹¹⁸ foresees a reporting threshold whereby a non financial entity could be required to report its trades to the trade repository if the size of its derivatives position exceeds a certain threshold i.e. it could be deemed to have become systematically important.

(64) What is your opinion on the three suggested modifications to the exemptions? Please explain the reasons for your views.

5.3. Definition of other derivative financial instrument

There are several aspects to consider in determining whether an OTC derivative contract on commodities which can be physically settled has the characteristics of other financial instruments¹¹⁹. If physical delivery takes place after more than two trading days or after the period generally accepted in the market as the standard delivery time, the contract will meet the definition of a financial instrument if it fulfils all the following conditions:

116 See Article 48 of Directive 2006/49/EC

117 See section 6 below

118 COM(2010) 484, Article 7

119 Articles 38 and 39 of Regulation 1287/2006.

- a) it is traded on or is equivalent to a contract traded on a regulated market, MTF or similar third country facility;
- b) it is cleared by a central counterparty (CCP) or is subject to the payment of margin; and
- c) it is a standardized contract in terms of price, lot, date of delivery, etc.

Taking into account the Commission proposal on OTC derivatives, central counterparties and trade repositories,¹²⁰ the Commission services consider that the criterion of whether a contract is cleared by a CCP or subject to margining¹²¹ could be deleted from the framework directive and implementing regulation as a condition of meeting the definition of other financial instrument. The Commission services consider that if an OTC physically settled contract meets the two other criteria mentioned above (i.e. similar to an exchange trade contract and standardised), it would be sufficient to assume this contract presents the same characteristics as other derivative financial instruments. It would then be the responsibility of ESMA to identify which contracts present a systemic risk and therefore need to be cleared.

(65) What is your opinion about removing the criterion of whether the contract is cleared by a CCP or subject to margining from the definition of other derivative financial instrument in the framework directive and implementing regulation? Please explain the reasons for your views.

5.4. Emission allowances

Emission allowances are an instrument created by the Emissions Trading Scheme Directive.¹²² The nature and characteristics of these allowances (certificate giving the right to emit 1 metric tonne of CO₂) could lend themselves to be classified as an intangible asset or a physical commodity. Emission allowances themselves are not classified as financial instruments under MiFID.¹²³ On the other hand, derivative contracts on these allowances (and other environmental credits) are financial instruments under MiFID under the same criteria as derivatives on commodities.¹²⁴

The Commission services note that the activity of carbon markets aims to satisfy specific public policy objectives in the area of climate change. Classification of emission allowances as financial instruments would have a major regulatory impact on the carbon market which brings together not only large industrial players with requisite capacity and expertise in the financial field or financial firms operating as intermediaries and proprietary investors but also smaller compliance buyers, including SMEs, currently with relatively limited exposure to the financial markets as a whole.

¹²⁰ COM(2010) 484, especially Article 3 creating the clearing obligation

¹²¹ Annex I, Section C(7) and (10) of Directive 2004/39/EC and Article 38(1)(b) of Regulation 1287/2006.

¹²² As created by Directive 2003/87/EC O.J. L 275 25.10.2003.

¹²³ The legal classification of emission allowances is not uniform in the Member States. Some Member States consider emission allowances as property rights, whereas others consider them personal rights. Romania has classified them as financial instruments.

¹²⁴ See Section C(10) of Annex of Directive 2004/39/EC and Articles 38(3) and 39 of Regulation 1287/2006. Nonetheless, it has been suggested that the concept of emission allowances in the framework directive should explicitly refer to units recognised for compliance with the requirements of the Emissions Trading Scheme directive (Directive 2003/87/EC).

More recently, there have been calls to extend the responsibilities of financial regulators to the supervision of secondary trading of spot emission allowances in addition to the derivatives market they already oversee.¹²⁵ Supervision of trading of spot emission allowances would be a natural extension of their new supervisory duties relating to the auctioning of emission allowances.¹²⁶ The supervision of secondary spot trading will be explored by the Commission in 2011 as part of its broader study on market oversight in the European carbon market pursuant to Article 12(1a) of Directive 2003/87/EC.¹²⁷

In the light of recent debates concerning the regulation of carbon markets¹²⁸, the Commission services consider that more in-depth study is required to assess the suitability and proportionality of classifying emission allowances as financial instruments. That approach will be examined in the forthcoming study as one of the options available to enhance the level of market oversight in the European carbon market. That study will involve a separate stakeholder consultation.

(66) What is your opinion on whether to classify emission allowances as financial instruments? Please explain the reasons for your views.

6. TRANSACTION REPORTING

Transaction reporting under MiFID enables supervisors to monitor the activities of investment firms and ensure compliance with MiFID, and to monitor for abuses under the Market Abuse Directive (MAD). Investment firms are required to report to competent authorities all trades in all financial instruments admitted to trading on a regulated market, regardless of whether the trade takes place on that market or not.¹²⁹

Transaction reporting is also useful for general market monitoring, as it provides insight into how firms and markets behave. Records of trading activity can be used by supervisors for various purposes, including monitoring market stability, cases of short selling, and analysing market trends including speculation during times of uncertainty. Notably, transaction reporting can reveal how individual positions are created, give insight into trading patterns between firms, and be used for micro-prudential supervision.

125 See the report "La régulation des marchés du CO2: rapport de la mission confiée à Michel Prada" commissioned by the French Ministry of Finance, C. Lagarde, and released on 19 April 2010.

126 As foreseen in Commission Regulation No 1031/2010 on the timing, administration and other aspects of auctioning of greenhouse gas emission allowances pursuant to Directive 2003/87/EC of the European Parliament and the Council establishing a scheme for greenhouse gas emission allowances trading within the Community <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:302:0001:0041:EN:PDF>

127 In its forthcoming Communication to the European Parliament and to the Council, the Commission will provide a preliminary assessment of the current levels of protection of the carbon market from market misconduct and abuse. The Communication will also outline the next steps foreseen by the Commission in this field.

128 Among others, EU financial and energy regulators have underlined the interdependencies between electricity and gas markets and other markets, such as emission allowances as well as other energy commodities (e.g. oil and coal). The market participants are often the same and there are close linkages in price formation, suggesting spot allowances trading could benefit from identical rules as EU electricity and gas markets. On the other hand some have suggested that EUAs should be classified as financial instruments under MiFID.

129 Article 25(3) of Directive 2004/39/EC and Articles 10 to 14 of Regulation 1287/2006.

The current scope and functioning of transaction presents specific challenges to be addressed. First, because market supervision is the main reason for transaction reporting, the requirements under MiFID need to mirror the scope of the MAD. The ongoing review of the latter compels a number of changes. Second, reporting requirements today diverge between Member States, which adds costs for firms and limits the use of trade reports for competent authorities. Finally, for cost and efficiency purposes, double reporting of trades under MiFID and the recently proposed reporting requirements to trade repositories should be avoided.¹³⁰

6.1. Scope

The current transaction reporting requirements apply to financial instruments admitted to trading on a regulated market, including transactions in such an instrument executed outside the market, notably on an MTF or OTC. In order to ensure that transaction reporting captures all relevant trading under MAD, some changes are necessary.

First, MAD will likely be extended to financial instruments admitted to trading or traded only on MTF's,¹³¹ as well as possibly to other instruments only traded on organised trading facilities outlined in Section 2.2 above.¹³² The latter transactions are currently considered to be OTC trades. Extending reporting requirements to all transactions in financial instruments admitted to trading on an MTF or an organised trading facility would ensure that all transactions executed on these facilities are captured, including when such transactions take place OTC.

Second, market manipulation by way of instruments that can influence the price of a financial instrument traded on a regulated market, MTF or organised trading facility outlined in Section 2.2 above is not explicitly covered under MAD. When such instruments are not themselves traded on organised trading platforms, transaction reporting under MiFID does not apply either. However, MAD is foreseen to be amended to this effect, necessitating a corresponding change to capture this type of OTC trading in MiFID.

Third, the MAD provisions against using inside information apply to all financial instruments whose value depends on that of a financial instrument traded on a regulated market. This includes depositary receipts. Transactions in such instruments currently do not need to be reported under MiFID when they are not themselves traded on organised trading platforms¹³³. Yet this type of OTC trading is already in scope of the MAD provisions today.

Fourth, the Commission services are considering an extension of the MAD to market manipulation of commodities markets through commodity derivatives markets. Commodity derivatives may be used to manipulate markets in the underlying

130 COM(2010) 484

131 Some Member States have already extended the scope of MAD to such instruments. See CESR Review Panel report MAD Options and Discretions 2009 CESR/09-1120

132 As described in section 2.2 above, the Commission services consider it necessary to define admission to trading as the decision by the operator of a regulated market, MTF, or organised trading facility to allow a financial instrument to be traded on its systems.

133 However, by way of recital 45 of Directive 2004/39/EC Member States have the option to extend reporting to instruments that are not admitted to trading on a regulated market.

commodity. Such behaviour may not be caught under the current text of the MAD, as the commodity itself will typically not be a financial instrument. This extension of the MAD would therefore need to be followed in MiFID by extending the transaction reporting obligation to all commodity derivatives, including those which are only traded OTC.

Fifth, regulated markets, MTFs, or other organised trading facilities outlined in Section 2.2 above may currently allow access to persons who are not authorised as investment firms under MiFID, and which are currently not subject to transaction reporting obligations, but are in scope of the market abuse provisions. This situation can impair the quality of market monitoring and supervision.

Finally, MAD will also likely be extended to capture attempted market abuse. As attempted market abuse is not limited to transactions in financial instruments, but also extends to orders to trade, this extension creates the need for consolidated and comparable order information. This information is currently available from trading platforms, but not all supervisors have access to it on an ongoing basis, nor is the information stored in a systematic way. Notably, the format and time may differ from market to market.

In this context, the Commission services consider that the scope of transaction reporting could be amended to:¹³⁴

- a) Extend the scope of transaction reporting in the framework directive to all transactions in financial instruments that are admitted to trading or traded on a MTF or an organised trading facility outlined in Section 2.2 above or that are related to the credit risk of a single issuer of such financial instruments.
- b) Extend the scope of transaction reporting in the framework directive to cover all financial instruments the value of which correlates with the value of a financial instrument traded on a regulated market, MTF or organised trading facility.
- c) Extend the scope of transaction reporting in the framework directive to depositary receipts that are related to a financial instrument that is admitted to trading or traded on a regulated market, a MTF or an organised trading facility outlined in Section 2.2 above.¹³⁵
- d) Extend transaction reporting in the framework directive to commodity derivatives that are not admitted to trading or traded on a regulated market, a MTF or an organised trading facility outlined in Section 2.2 above.
- e) Introduce a transaction reporting obligation in the framework directive on regulated markets, MTFs and any organised trading facilities outlined in Section 2.2 above that offer access to firms not authorised as investment firms or credit institutions.

134 By amending Article 25(3) of Directive 2004/39/EC

135 See CESR consultation paper on "Transaction reporting on OTC Derivatives and Extension of the Scope of Transaction Reporting Obligation", 19 July 2010, CESR/10-809

- f) Amend the framework directive to oblige regulated markets, MTF's and organised trading facilities to store order data in a manner accessible to supervisors for at least five years.

- (67) **What is your opinion on the extension of the transaction reporting regime to transactions in all financial instruments that are admitted to trading or traded on the above platforms and systems? Please explain the reasons for your views.**
- (68) **What is your opinion on the extension of the transaction reporting regime to transactions in all financial instruments the value of which correlates with the value of financial instruments that are admitted to trading or traded on the above platforms and systems? Please explain the reasons for your views.**
- (69) **What is your opinion on the extension of the transaction reporting regime to transactions in depositary receipts that are related to financial instruments that are admitted to trading or traded on the above platforms and systems? Please explain the reasons for your views.**
- (70) **What is your opinion on the extension of the transaction reporting regime to transactions in all commodity derivatives? Please explain the reasons for your views.**
- (71) **Do you consider that the extension of transaction reporting to all correlated instruments and to all commodity derivatives captures all relevant OTC trading? Please explain the reasons for your views.**
- (72) **What is your opinion of an obligation for regulated markets, MTFs and other alternative trading venues to report the transactions of non-authorised members or participants under MiFID? Please explain the reasons for your views.**
- (73) **What is your opinion on the introduction of an obligation to store order data? Please explain the reasons for your views.**
- (74) **What is your opinion on requiring greater harmonisation of the storage of order data? Please explain the reasons for your views.**

6.2. Content of reporting

Various differences in national implementation and interpretation regarding transaction reporting have led to diverging reporting requirements. In order to minimise differing requirements, reduce costs and improve efficiency in the exchange of transaction information between regulators, specific changes are necessary.

First, Member States take differing views on which legs of the process of order execution constitute executing a transaction. Some Member States consider that only the execution of a transaction on an organised venue or OTC is reportable, while others consider that changing the essential characteristics of an order also constitutes a reportable transaction. There is also disagreement as to whether the aggregation of orders is considered to be executing the order.

Second, national schemes differ as regards collecting data that identifies the person who has made the underlying investment decision. Some Member States do not require this information at all. This hampers automated detection of market abuse, and complicates investigations of possible market abuse as such information first needs to be gathered from investment firms. Member States that collect this information do so either through direct reporting by the client-facing entity, or by passing on client information down the execution chain. As a result, the number of transaction legs that need to be reported, as well as the way the client and counterparty fields are populated in a transaction report differs across the Member States. This divergence limits the use of transaction reporting for purposes of detecting and investigating possible cases of market abuse, because it hinders the exchange of information between supervisors. It also leads to diverging obligations on firms.

Third, the Commission services are also considering whether, in order to provide further information to monitor for market abuse, transaction reports could identify the trader within a firm who executes the transaction. This field is a so-called "trader ID". When the investment decision is made by an automated system (i.e. when a computer algorithm has decided on the aspects of execution of the order such as timing, quantity and price), the transaction report could identify an algorithm as having made the investment decision.

Further, it will be necessary for implementing measures to fully harmonise the content of transaction reports as any differences between Member States not only create difficulties for firms but act as an obstacle to competent authorities being able to exchange and understand exchanged information on transactions. Therefore, subsequent clarifications to transaction reporting are needed in the implementing acts.

In this context, the Commission services consider that the transaction reporting obligations could be modified as follows:

- a) Amend the implementing regulation 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.¹³⁶
- b) Amend the framework directive to introduce an obligation on firms that receive and transmit or otherwise handle orders but which are not executing transactions in the above sense to transmit the required details of such orders to the receiving investment firm¹³⁷.
- c) Amend the framework directive to require transaction reports to include means of identifying the person who has made the investment decision (the client identifier)¹³⁸ and the trader who executes the transaction. Transaction reports would need to identify the person who has made the investment decision through the chain of order transmission to the final execution of the transaction. This would require that all entities in a chain of transactions have the obligation to

136 By amending article 5 of regulation 1287/2006.

137 By amending Article 25 of Directive 2004/39/EC

138 Amending Article 25(4) of Directive 2004/39 and Article 13(4) of Regulation 1287/2006

pass on all the details of the trade including client identifiers as in b) above they are themselves not subject to transaction reporting.

- d) Amend the framework directive to allow for the adoption of implementing acts on a common European transaction reporting format and content, including the reporting form, identification of the instrument traded, date and time, price against which the transaction took place, identification of the reporting parties, identification of the client, trading capacity, number of the report, technical format of transmission, and way of transmission.¹³⁹

(75) What is your opinion on the suggested specification of what constitutes a transaction for reporting purposes? Please explain the reasons for your views.

(76) How do you consider that the use of client identifiers may best be further harmonised? Please explain the reasons for your views.

(77) What is your opinion on the introduction of an obligation to transmit required details of orders when not subject to a reporting obligation? Please explain the reasons for your views.

(78) What is your opinion on the introduction of a separate trader ID? Please explain the reasons for your views.

(79) What is your opinion on introducing implementing acts on a common European transaction reporting format and content? Please explain the reasons for your views.

6.3. Reporting channels

Transactions need to be reported to competent authorities, who then exchange this information as necessary for market supervision purposes.¹⁴⁰ The reporting obligation could be met by the investment firm itself, a third party acting on its behalf or by a trade matching or reporting system approved by the competent authority or by the regulated market or MTF through whose systems the transaction was completed.¹⁴¹

First, reporting to different competent authorities who then exchange this information is giving rise to certain inefficiencies. This is because investment firms need to report to different competent authorities depending on where they execute a transaction and competent authorities need to develop and maintain IT infrastructure to exchange the transaction reports.

Second, supervisors' enforcement powers over reporting channels that are not regulated entities are unclear. Such entities need to be approved, but the conditions for approval are not specified. This has possible data quality implications.

139 CESR has already put forward numerous proposals including a third trading capacity (client facilitation) in addition to those of agent and principal, and standards for mandatory client and counterparty identifiers (CESR/10-808)

140 See CESR Level 3 guidelines on transaction reporting (CESR/07-301)

141 Article 25(5) of Directive 2004/39/EC.

Third, the Commission's proposal on OTC derivatives, central counterparties and trade repositories (EMIR)¹⁴² captures trading in derivatives which is or may become reportable under MiFID.¹⁴³ This would lead to double reporting requirements on investment firms.

In this context, the Commission services consider that the transaction reporting obligations could be modified as follows:

- a) Amend the framework directive¹⁴⁴ to explicitly enable direct reporting by investment firms to a reporting mechanism at EU level. Transaction reports could be sent to such a mechanism, i.e. a database permanently accessible to competent authorities. This would remove the costs of running separate databases by the competent authorities.
- b) Amend the framework directive¹⁴⁵ to clarify that third parties reporting on behalf of investment firms should be approved by competent authorities as an "Approved Reporting Mechanism" (ARM) on condition that they can meet the requirements imposed by article 25, and are subject to the same sanctions that apply to the firm on whose behalf the report is made.
- c) Amend the framework directive¹⁴⁶ to waive the MiFID reporting obligation on an investment firm which has already reported an OTC contract to a trade repository or competent authority under EMIR and approved as an ARM under MiFID.

(80) What is your opinion on the possibility of transaction reporting directly to a reporting mechanism at EU level? Please explain the reasons for your views.

(81) What is your opinion on clarifying that third parties reporting on behalf of investment firms need to be approved by the supervisor as an Approved Reporting Mechanism? Please explain the reasons for your views.

(82) What is your opinion on waiving the MiFID reporting obligation on an investment firm which has already reported an OTC contract to a trade repository or competent authority under EMIR? Please explain the reasons for your views.

(83) What is your opinion on requiring trade repositories under EMIR to be approved as an ARM under MiFID? Please explain the reasons for your views.

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143 EMIR contains the obligation for financial counterparties and non-financial-institutions above a certain threshold to report the details of all OTC derivative contracts and derivatives contracts executed on MTFs to trade repositories, i.e. to entities that centrally collect and maintain the records of OTC derivatives. Competent authorities will have access to the information stored in the trade repositories. Where there is no trade repository available, the OTC derivatives contract should be reported to the supervisor.

144 By amending Article 25(3) of Directive 2004/39/EC

145 By amending Article 25(5) of Directive 2004/39/EC

146 By amending Article 25(5) of Directive 2004/39/EC

7. INVESTOR PROTECTION AND PROVISION OF INVESTMENT SERVICES

Several regulators and market participants have raised concerns in the area of investor protection both with regard to the content and the practical application of certain MiFID provisions. The latter referred to cases of advice of unsuitable products or the impact of complex products on investors who did not fully appreciate their risk. Also in light of the experience of the financial crisis, the Commission services consider that a revision of several provisions is necessary.

These relate to three areas:

1. Some modifications are suggested in order to ensure that the scope of the directive is sufficiently clear and includes financial products, services, practices and entities which are currently not covered;
2. The conduct of business rules, while comprehensive, detailed and calibrated by service and investor-type (retail or professional), require some modifications in light of the financial crisis; and
3. Specific updates to the authorisation provisions and the organisational requirements and operational arrangements, policies and procedures which firms have to maintain are needed in order to address some deficiencies present in the provision of investment services.

In the area of investor protection, the present consultation has also to be read in conjunction with the Commission Green Paper on Corporate Governance in Financial Institutions and Remuneration Policies¹⁴⁷, the Commission Communication on Packaged Retail Investment Products (PRIIPs)¹⁴⁸ and with the subsequent contributions from stakeholders to the consultation on legislative steps for the PRIIPs initiative¹⁴⁹, as well as the Consultation on Legal Certainty of Securities Holding and Dispositions.¹⁵⁰ The present paper elaborates on some issues covered by these work streams; nevertheless all issues which imply a modification or supplementing MiFID with additional rules will be part of the MiFID legislative proposal.

The present document does not deal with remuneration policies and practices in the perspective of excessive risk-taking and short termism. Investment firms and credit institutions providing services in accordance with MiFID are already fully covered under the new Directive amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review

147 COM (2010) 284 final

148 COM(2009) 204 final.

149 Working Document of the Commission Services (DG Internal Market) - Consultation by Commission services on legislative steps for the Packaged Retail Investment Products initiative, published on 26 November 2010 (http://ec.europa.eu/internal_market/consultations/2010/priips_en.htm). In line with the Working Document, the present consultation document on the MiFID review does not cover so-called "pre-contractual disclosures" (rules on the 'key investor information' document, or KIID).

150 See http://ec.europa.eu/internal_market/consultations/docs/2010/securities/consultation_paper_en.pdf As a result of this ongoing consultation, the question of changing the ancillary service of "safekeeping and administration of financial instruments for the account of clients, including custodianship and related services such as cash/collateral management" (Annex I, Section B(1) of Directive 2004/39/EC) to an investment service will not be consulted upon in this document.

of remuneration policies (so called CRD III¹⁵¹) and under Commission Recommendation of 30 April 2009 on remuneration policies in the financial services sector. According to the CRD III, CESR is required to cooperate closely with CEBS in ensuring the existence of guidelines on remuneration policies in the provision of investment services and activities, in the perspective of the Directive (Article 22 of Directive 2006/48/EC).

7.1. Scope of the Directive

The Commission services consider that improvements are necessary in three areas¹⁵².

7.1.1. Optional exemptions for some investment service providers

Member States have the option not to apply MiFID to firms or persons providing reception and transmission of orders and/or investment advice in relation to a broad range of financial instruments.¹⁵³ Member States may only apply this exemption when the activities of the persons are regulated at national level, but MiFID does not specify any details of what this national regulation should consist of. These entities cannot provide services cross border, and indeed in most cases do not appear to be interested to do so.¹⁵⁴

The financial crisis has underlined that, amid the complexity of financial markets and products, investors depend to a large extent on suitable recommendations provided by professional advisers. Investors should enjoy the same level of protection irrespective of the location or the nature of the service providers. Exempting some service providers even on a national basis without setting a minimum regulatory framework for investor protection no longer seems appropriate. On the other hand, these service providers are often small and medium sized firms (or even natural persons), frequently reflecting the development of national markets; thus the application of the whole MiFID framework may appear disproportionate.

In the light of the above, the Commission services consider that, while it is appropriate for Member States to retain the possibility to exempt certain entities providing advice (with or without the subsequent reception and transmission of clients' orders) from the Directive, these firms could be subject, in national legislation, to requirements analogous to the MiFID ones in the following areas:

- a) proper authorisation process, including the assessment of fit and proper criteria¹⁵⁵;
- b) information to clients¹⁵⁶;
- c) suitability test¹⁵⁷;

151 The directive is awaiting publication.

152 A fourth change in the scope of the directive concerns the question of safekeeping of financial instruments in the above footnote.

153 Article 3 of Directive 2004/39/EC

154 These entities are often small firms, or even individuals, and are not allowed to hold clients' funds or securities.

155 Article 5 and 9 of Directive 2004/39/EC

156 Article 19 (2) and (3) of Directive 2004/39/EC

- d) payments received from third parties (inducements);
- e) reporting to clients¹⁵⁸ and
- f) duty to act in the best interest of the client when transmitting orders received from clients.¹⁵⁹

These principles would be introduced in Article 3 of MiFID in order to narrow the scope of the exemption by circumscribing the powers of Member States in regulating these entities and in order to ensure adequate protection of investors irrespective of the entity providing the services.

(84) What is your opinion about limiting the optional exemptions under Article 3 of MiFID? What is your opinion about obliging Member States to apply to the exempted entities requirements analogous to the MiFID conduct of business rules for the provision of investment advice and fit and proper criteria? Please explain the reasons for your views.

7.1.2. Application of MiFID to structured deposits

In the context of the Communication on packaged retail investment products (PRIPs),¹⁶⁰ the Commission has underlined the importance of ensuring a more consistent regulatory approach concerning the distribution of different financial products to retail investors, which however satisfy similar investor needs and raise comparable investor protection challenges. Most of the elements of the MiFID regime were identified as a benchmark for the sale of different categories of PRIPs, even when they are covered under other directives, as in the case of some insurance products.¹⁶¹

In light of the above, the Commission services consider that relevant parts of MiFID could be extended to cover products which are currently not regulated at EU level. This is the case for structured deposits,¹⁶² which have similar characteristics as other categories of financial instruments already covered under MiFID, such as a long term investment objective, the structured form and the active marketing to retail investors. Therefore, the Commission services consider that MiFID conduct of business and conflicts of interest rules could be extended to the advised and non-advised sale of these products by credit institutions.¹⁶³

157 Article 19 (4) of Directive 2004/39/EC

158 Article 19 (8) of Directive 2004/39/EC

159 Article 45 (7) of Directive 2006/73/EC

160 See consultation of Commission services on legislative steps for the Packaged Retail Investment Products initiative of 26 November 2010 (http://ec.europa.eu/internal_market/consultations/docs/2010/priips/consultation_paper_en.pdf) and Communication on Packaged Retail Investment Products COM(2009) 204 final (29 April 2009) and update in the form a working paper on 16 December 2009.

161 This is also in line with current practice in various Member States where MiFID investor protection rules apply also to some non-MiFID products.

162 Working document of the Commission services published on 26/11/2010, p. 8. – See also Report of the 3L3 Task Force on Packaged Retail Investment Products (PRIPs) , 6/10/2010, p. 18.

163 Amending Article 1(2) in relation to the applicability of MiFID to credit institutions in Directive 2004/39/EC

(85) What is your opinion on extending MiFID to cover the sale of structured deposits by credit institutions? Do you consider that other categories of products could be covered? Please explain the reasons for your views.

7.1.3. Direct sales by investment firms and credit institutions

Some national regulators have raised concerns with respect to the applicability of MiFID when investment firms or credit institutions issue and sell their own securities. While the application of MiFID is clear when investment advice is provided as part of the sale, greater clarity is needed in the case of non-advised services, where the investment firm or bank could be considered not to be providing a MiFID service.

Some practical issues have also emerged with respect to investment firms and credit institutions distributing products to investors on the basis of an agreement with the issuer in the provision of the services of placing and underwriting. In particular, it seems necessary to clarify in practice the situation of investment firms that can be acting on behalf of an issuer and, as part of the same transaction, on behalf of the investor as well.¹⁶⁴

On the first issue, the Commission services consider that it would be necessary to specify that MiFID also applies to investment firms and credit institutions selling their own securities when not providing any advice. To this end, the definition of the service of execution of orders on behalf of clients could be modified in order to also include the direct sale of their own securities by banks and investment firms.¹⁶⁵

Concerning the second point, the Commission Services consider that MiFID conduct of business rules clearly apply to the provision of services to investors, irrespective of the circumstance that a firm is acting, at the same time, on behalf of the issuer and of the investor. However, in order to ensure a convergent application of these principles in concrete situations, implementing measures should be adopted in this area.

(86) What is your opinion about applying MiFID rules to credit institutions and investment firms when, in the issuance phase, they sell financial instruments they issue, even when advice is not provided? What is your opinion on whether, to this end, the definition of the service of execution of orders would include direct sales of financial instruments by banks and investment firms? Please explain the reasons for your views.

7.2. Conduct of business obligations

MiFID establishes the general obligation for investment firms and credit institutions to act honestly, fairly and professionally in accordance with the best interests of their clients when providing investment services.¹⁶⁶ Based on these general principles, specific conduct of business rules are further spelled out. These rules concern the information to

¹⁶⁴ Additional Information in Relation to the Review of MiFID CESR/10-860

¹⁶⁵ Amending Article 4(1)(5) of Directive 2004/39/EC

¹⁶⁶ Article 19(1) of Directive 2004/39/EC.

be given to clients before¹⁶⁷ and after¹⁶⁸ the provision of investment services, as well as "know-your-customer" tests adapted to the type of client and investment service.¹⁶⁹ Finally, any payments likely to influence the choice of service or financial instrument (*inducements*) have to comply with specific requirements.¹⁷⁰

Conduct of business rules are calibrated to the characteristics of different categories of investors and their need of protection. For this purpose, clients are divided into three categories - *retail clients*, *professional clients*,¹⁷¹ and *eligible counterparties*.¹⁷² Professional clients are in turn divided between professional clients *per se* (such as banks, pension funds, investment funds and other financial institutions) and professional clients on request.

Experience since the application of the Directive and the financial crisis have revealed the need to assess whether this differentiated treatment is still adequate.

7.2.1. "Execution only" services

MiFID allows investment firms to provide investors with a means to buy and sell certain financial instruments in the market without undergoing any assessment of the appropriateness of the given product - that is, the assessment against knowledge and experience of the investor.¹⁷³ These "execution-only" services are only available when certain conditions are fulfilled, namely when it involves so-called non-complex financial instruments.¹⁷⁴

There seems to be a certain degree of uncertainty on what can qualify as a non-complex product and on the services that can be covered by this regime¹⁷⁵. The Commission services suggest two alternative options:

Option A

167 Article 19(3) of Directive 2004/39/EC and Articles 28-34 of Directive 2006/73/EC, Article 21(3) of Directive 2004/39/EC and Article 46(2) of Directive 2006/73/EC.

168 Article 19(8) of Directive 2004/39/EC and Articles 40-43 of Directive 2006/73/EC.

169 When providing investment advice or portfolio management firms should conduct a suitability test taking into consideration the knowledge and experience, the financial situation and the investment objectives of the client (Article 19(4) of Directive 2004/39/EC and Articles 35 and 37 of Directive 2006/73/EC). When providing the other services, firms should assess the appropriateness of the service for the client according to his knowledge and experience (Article 19(5) of Directive 2004/39/EC and Article 36, 37 of Directive 2006/73/EC). Under specific circumstances intermediaries may provide services often described as "execution-only" services, where they are not obliged to assess the appropriateness of the service for the client (Article 19(6) of Directive 2004/39/EC and Article 38 of Directive 2006/73/EC).

170 Article 26 of the 2006/73/EC regulating different categories of inducements, including the obligation to disclose third party inducement and ensure that they are designed to enhance the quality of the service for the client and do not impair compliance with firms' duty to act in the best interest of the client.

171 Annex II to Directive 2004/39/EC

172 Article 24 of Directive 2004/39/EC. This category only exists in relation to certain services (particularly, execution of orders), while it does not apply to the provision of investment advice and portfolio management

173 Article 19(6) of Directive 2004/39/EC

174 The relevant instruments are specified in the first indent of Article 19(6) of Directive 2004/39/EC; further criteria to identify financial instruments that may be subject to "execution-only" regime are specified under Article 38 of Directive 2006/73/EC.

175 See also CESR proposal for modifying Article 19(6) in CESR/10-859, p.25-31

Supplementing Article 19(6) with the following elements:

- a) Amending the reference to "shares" in Article 19 (6) in the framework directive, in order to clarify that these shares that may be treated as automatically non-complex are shares admitted to trading on a regulated market or MTF or on an equivalent third country market, where these are shares in companies, and excluding shares in collective investment undertakings, convertible shares and other shares that embed a derivative;
- b) Differentiating the categories of money market instruments, bonds or securitised debt in order to limit their classification as non-complex instruments in the following cases:
 - bonds and other forms of securitised debt admitted to trading on a regulated market or on an equivalent third country market – excluding in any case those embedding a derivative such as convertible bonds and exchangeable bonds, or incorporating a structure which makes it difficult for the client to understand the risk involved;
 - money market instruments – excluding asset-backed securities and other structured instruments that embed a derivative or incorporate structures which make it difficult for the client to understand the risk involved.
- c) The current regime would also be modified in order to exclude the provision of execution-only services when the ancillary service of granting of credit or loans to the client to allow the client to carry out the transaction in one or more financial instruments, is also provided.¹⁷⁶ The reason for this need for an exclusion is because the granting of credits or loans increases the client's leverage and risk exposure and the overall complexity of the transaction; and
- d) In addition to the proposals under (a), (b) and (c), a differentiation could also be introduced for UCITS in Article 19(6) in order to further refine the categories of instruments which may be subject to the execution only regime. The current framework, where UCITS are always classified as non-complex instruments, could evolve in order to take into account the adoption of complex portfolio management techniques in the management of some UCITS.

Option B

Deleting Article 19(6)

This implies abolition of the execution only regime. In support of this option it may be argued that retail clients – who are essentially concerned by the provision of execution only – should always expect a higher standard of service from intermediaries, including on-line brokerage which is the typical channel for this kind of services.

(87) What is your opinion of the suggested modifications of certain categories of instruments (notably shares, money market instruments, bonds

and securitised debt), in the context of so-called "execution only" services? Please explain the reasons for your views.

(88) What is your opinion about the exclusion of the provision of "execution-only" services when the ancillary service of granting credits or loans to the client (Annex I, section B (2) of MiFID) is also provided? Please explain the reasons for your views.

(89) Do you consider that all or some UCITS could be excluded from the list of non-complex financial instruments? In the case of a partial exclusion of certain UCITS, what criteria could be adopted to identify more complex UCITS within the overall population of UCITS? Please explain the reasons for your views.

(90) Do you consider that, in the light of the intrinsic complexity of investment services, the "execution-only" regime should be abolished? Please explain the reasons for your views.

7.2.2. *Investment advice*¹⁷⁷

In the context of recent debates on the quality of investment advice, including the debate on PRIPs, several possible areas for improvement have emerged.

- 1) Under MiFID¹⁷⁸ intermediaries providing investment advice are not expressly required to explain the basis on which they provide advice (e.g. the range of products they consider and assess) and more clarity is thus needed as to the kind of service provided by the intermediary. The Commission services consider that the framework directive:¹⁷⁹
 - a) could include a requirement for intermediaries to inform the investor whether they give advice on the basis of an independent and fair analysis;
 - b) could provide that, when the investment firm informs the client that advice is based on an independent and fair analysis:
 - it would be obliged to assess a sufficiently large number of financial instruments available on the market, notably, financial instruments of different types and from different providers. Implementing measures should be adopted for a uniform application of the new requirements;
 - the firm would be prohibited from accepting any payments or benefits from any product providers (see section 6.2.4. on inducements).
- 2) While a general obligation to report to clients on the services provided is already in place in the framework directive,¹⁸⁰ the Commission services consider appropriate introducing further details concerning investment advice in the implementing

¹⁷⁷ Investment advice as defined in Article 4(1)(4) of Directive 2004/39/EC and 52 of Directive 2006/73/EC.

¹⁷⁸ Namely Article 19(3) of Directive 2004/39/EC

¹⁷⁹ Article 19(3) of Directive 2004/39/EC and Articles 30 of Directive 2006/73/EC

¹⁸⁰ Article 19(8) of Directive 2004/39/EC

directive. Notably firms providing advice would report personally to the client in writing the underlying reasons for the advice provided, including the explanation about how the advice meets the investor's profile.¹⁸¹

- 3) The Commission services consider that, as a consequence of the provision of advice, investors could expect, or could be able to require, a longer term assistance from intermediaries providing the service. Therefore:
 - a) The firm would be required to report regularly – at least every six months - to the client about the market value (or the fair value when the market value is not available) and the performance of the financial instruments recommended to the client, except in the case of complex products where the reporting could be quarterly (see section 7.2.3 below). In addition, the firm would in any case report when material modifications in the situation of the financial instruments recommended to the client occur;¹⁸²
 - b) The firm would request the client, on an annual basis, to update the information concerning his personal circumstances.¹⁸³ If the client refuses to do so, the firm would be allowed to assume that the initial circumstances are still unchanged; and
 - c) The firm would confirm, at least on an annual basis that, based on the evolution of the financial instruments initially recommended and of the personal circumstances of the client, those instruments are still suitable to the client's personal situation, including in terms of risk diversification of his overall investments.¹⁸⁴
- 4) The Commission services consider that the implementing directive could be modified in order to clarify that investment advice may also be provided through distribution channels, such as the internet.¹⁸⁵

(91) What is your opinion of the suggestion that intermediaries providing investment advice should: 1) inform the client, prior to the provision of the service, about the basis on which advice is provided; 2) in the case of advice based on a fair analysis of the market, consider a sufficiently large number of financial instruments from different providers? Please explain the reasons for your views.

(92) What is your opinion about obliging intermediaries to provide advice to specify in writing to the client the underlying reasons for the advice provided, including the explanation on how the advice meets the client's profile? Please explain the reasons for your views.

181 Introducing in Directive 2006/73/EC a specific provision implementing Article 19(8) of Directive 2004/39/EC when advice is provided.

182 Introducing a new Article in Section 4, Chapter III of Directive 2006/73/EC

183 Amending Article 35 of Directive 2006/73/EC

184 *ibid*

185 In the Technical Advice to the Commission in the context of the MiFID review, CESR notices that the current wording of Article 52 of Directive 2006/73/EC may lead to the wrong interpretation that personal recommendations issued through distribution channels cannot qualify as investment advice (CESR/10-859, p. 32). Formal adjustments in the Directive are appropriate in order to clarify this wording.

(93) What is your opinion about obliging intermediaries to inform the clients about any relevant modifications in the situation of the financial instruments pertaining to them? Please explain the reasons for your views.

(94) What is your opinion about introducing an obligation for intermediaries providing advice to keep the situation of clients and financial instruments under review in order to confirm the continued suitability of the investments? Do you consider this obligation be limited to longer term investments? Do you consider this could be applied to all situations where advice has been provided or could the intermediary maintain the possibility not to offer this additional service? Please explain the reasons for your views.

7.2.3. Informing clients on complex products

Information and reporting requirements represent an important part of the MiFID investor protection framework.¹⁸⁶

As a result of the crisis, CESR has noted that there is a case for strengthening the right to request information for professional and retail clients who trade OTC derivatives and other complex or tailor-made products (e.g. structured products), although on an appropriately calibrated basis.¹⁸⁷ In addition to the protections foreseen in MiFID when customized financial instruments are traded with clients (notably, the "know your customer" obligation in the provision of investment advice), the Commission services consider that, as part of the firms' obligation to inform clients about financial instruments and to report on the services provided, the following three pieces of information could be made available to the client:

- a) Prior to the transaction, a risk/gain and valuation profile of the instrument in different market conditions;¹⁸⁸
- b) During the life of the product, quarterly valuations of such complex products.¹⁸⁹ The requirement of the independence and the integrity of the valuations could be foreseen. The firm could also be asked to exert continuous due diligence on the initial and subsequent valuation that are being provided to the client; and
- c) In the case of structured products, quarterly reporting on the evolution of the underlying assets during the lifetime of the product.

A further improvement could consist in introducing a general obligation for firms holding client financial instruments to inform the clients in a timely manner when material modifications in the situation of the financial instruments occur. This would complement the current obligation in the implementing directive to send to clients, at

¹⁸⁶ Recitals 44 and 45 and Article 31 of Directive 2006/73/EC

¹⁸⁷ CESR/10-860, p.3

¹⁸⁸ Amending Article 31 of Directive 2006/73/EC. Following the future developments on key investor information documents concerning PRIIPs, which also aims at improving knowledge and comprehensibility of risks, proper co-ordination between the two obligations will be ensured.

¹⁸⁹ Introducing a new Article to Section 4, Chapter III of Directive 2006/73/EC

least once a year, a statement of their assets.¹⁹⁰ These adjustments could be also expanded to cover eligible counterparties who currently do not benefit from any information and reporting requirements.¹⁹¹

Finally, since investors seem increasingly interested in the aspect of the social responsibility in the investment field, the Commission services consider appropriate to require investment firms to disclose any available information concerning ethical or socially oriented investment criteria in the context of information about financial instruments.¹⁹²

- (95) **What is your opinion about obliging intermediaries to provide clients, prior to the transaction, with a risk/gain and valuation profile of the instrument in different market conditions? Please explain the reasons for your views.**
- (96) **What is your opinion about obliging intermediaries also to provide clients with independent quarterly valuations of such complex products? In that case, what criteria should be adopted to ensure the independence and the integrity of the valuations?**
- (97) **What is your opinion about obliging intermediaries also to provide clients with quarterly reporting on the evolution of the underlying assets of structured finance products? Please explain the reasons for your views.**
- (98) **What is your opinion about introducing an obligation to inform clients about any material modification in the situation of the financial instruments held by firms on their behalf? Please explain the reasons for your views**
- (99) **What is your opinion about applying the information and reporting requirements concerning complex products and material modifications in the situation of financial instruments also to the relationship with eligible counterparties? Please explain the reasons for your views.**
- (100) **What is your opinion of, in the case of products adopting ethical or socially oriented investment criteria, obliging investment firms to inform clients thereof?**

7.2.4. *Inducements*

A series of issues with respect to the requirements regulating inducements merits review.

Firstly, disclosure is currently required prior to the provision of the services and it covers the existence, the nature and the amount of the inducements ("disclosure requirement"). The prior disclosure may be made in a summary form. If the amount of inducements

190 Article 43 of directive 2006/73/EC

191 Article 24 and Article 19 of Directive 2004/39/EC

192 Article 31 of Directive 2006/73/EC. Following the future developments on key investor information documents concerning PRIIPs, proper co-ordination between the two obligations will be ensured.

cannot be clearly ascertained, it is sufficient to disclose the method of calculating that amount.¹⁹³ From this, the following three key issues have emerged¹⁹⁴:

- a) There are difficulties in distinguishing between summary and detailed disclosures of inducements to clients;
- b) The current ex-ante disclosure is not complemented by any ex-post disclosure, even in cases when it is not possible to disclose the exact amount of inducements prior to the provision of the relevant service;
- c) Technical details as to the content of the disclosure (existence, nature and amount of inducements) are not provided in the directive and this has led to different implementation by firms.

Secondly the requirement that third parties' inducements would be designed to enhance the quality of the service to the client ("enhancement requirement") is important, in as much as it precludes simply relying on the mere disclosure of inducements. Nevertheless, some practical difficulties have appeared notably with respect to portfolio management and investment advice.

The Commission services consider that the following modifications could be introduced in the inducements regime:

- a) A modification of the disclosure requirement in the implementing directive in order to maintain the ex-ante detailed disclosure, abolish the possibility of disclosing inducements in summary form and introduce an ex-post reporting obligation (notably, in cases when the ex-ante disclosure referred to the methods of calculating inducements).
- b) Implementing acts could clarify the technical details of different items to be disclosed and could also define templates for disclosure in order to harmonise the presentation of inducements to clients.
- c) Further convergence of practical application aspects of the enhancement requirement through implementing acts to supervisors. For instance, in assessing whether the inducements have been designed to enhance the quality of the service to the client, supervisors would take into account the long term assistance provided by firms to their clients (as mentioned in previous paragraph 7.2.2).
- d) In the case of portfolio management banning third party inducements would be envisaged, because of the discretionary nature of this service and the possibility for the portfolio manager to take a decision without prior consent from the client.
- e) In the case of investment advice provided on an independent basis, third party inducements would be incompatible with the independent nature of the advice provided. Ban of third party inducements for the intermediary providing independent advice would consequently be envisaged.

193 Article 26 of Directive 2006/73/EC implementing Article 19(1) of Directive 2004/39/EC

194 CESR/10-860, p. 6

- (101) **What is your opinion of the removal of the possibility to provide a summary disclosure concerning inducements? Please explain the reasons for your views.**
- (102) **Do you consider that additional ex-post disclosure of inducements could be required when ex-ante disclosure has been limited to information methods of calculating inducements? Please explain the reasons for your views.**
- (103) **What is your opinion about banning inducements in the case of portfolio management and in the case of advice provided on an independent basis due to the specific nature of these services? Alternatively, what is your opinion about banning them in the case of all investment services? Please explain the reasons for your views.**

7.2.5. Provision of services to non-retail clients and classification of clients

The Commission services consider that the general framework of the client classification system provides an adequate and satisfactory degree of flexibility¹⁹⁵ and could thus remain unchanged. Nonetheless, the current crisis and alleged mis-selling practices involving local authorities, municipalities and corporate clients have shown that the ability of some non-retail clients to understand the risk they are exposed to, especially in the case of very complex products, may be inadequately reflected in the MiFID framework.

In line with the rationale of the directive to calibrate protection requirements to the different categories of clients, many detailed conduct of business requirements are not meaningful in the relationship between eligible counterparties in their multiple daily dealings. On the other hand, the overarching high level principle to act honestly, fairly and professionally and the obligation to be fair, clear and not misleading should apply irrespective of client categorization. In addition, the eligible counterparty regime applies to the provision of execution of orders, dealing on own account and reception and transmission of orders to categories of entities classified as counterparties (such as credit institutions). It does not currently differentiate between the products actually traded or different entities in the same category (e.g. smaller and bigger credit institutions). Finally, the implementing directive allows firms to assume that, in relation to the products and services for which the client is classified as a professional, he/she has the necessary level of experience and knowledge¹⁹⁶. Experience shows that, in practice, the presumption is often inaccurate since clients are generally classified as professionals without any differentiation between different products and services. Last but not least, recent alleged mis-selling has shown that the classification of local public authorities and municipalities raises uncertainty. Only the more experienced among them could be able to qualify for professional client status on-demand, while suitable flexibility for municipalities to access financial markets would be retained.

195 For instance, eligible counterparties may ask to be treated as professional or even retail clients in order to obtain more protective treatment.

196 Article 35 (2), first subparagraph, and Article 36 second subparagraph of Directive 2006/73/EC

As a result, the Commission services consider that some alternative or complementary options for modification can be envisaged:

- a) To clarify that the framework directive's principles to act honestly, fairly and professionally and the obligation to be fair, clear and not misleading also apply in the relationship with eligible counterparties.¹⁹⁷
- b) Appropriate modifications in the framework directive¹⁹⁸ would be introduced to limit the availability of the eligible counterparty regime in certain circumstances, and notably:
 - to exclude transactions in complex products (such as asset backed securities and non-standard OTC derivatives); and/or
 - to exclude non-financial undertakings and certain financial institutions from the eligible counterparty regime. The exclusion could be based on the size of the institutions (smaller institutions) or on the nature of the business (for instance, entities which are not active in the securities markets).
- c) The presumption that professional clients have the necessary level of experience and knowledge would be abolished or limited to less complex financial instruments in order to grant to professional clients a more rigorous assessment of suitability or appropriateness.¹⁹⁹
- d) Municipalities would be excluded from being classified as eligible counterparties or professional clients per se.²⁰⁰

(104) What is your opinion about retaining the current client classification regime in its general approach involving three categories of clients (eligible counterparties, professional and retail clients)? Please explain the reasons for your views.

(105) What are your suggestions for modification in the following areas:

- a) **Introduce, for eligible counterparties, the high level principle to act honestly, fairly and professionally and the obligation to be fair, clear and not misleading when informing the client;**
- b) **Introduce some limitations in the eligible counterparties regime. Limitations may refer to entities covered (such as non-financial undertakings and/or certain financial institutions) or financial instruments traded (such as asset backed securities and non-standard OTC derivatives); and/or**
- c) **Clarify the list of eligible counterparties and professional clients**

197 An amendment to Article 24 of Directive 2004/39/EC to this effect could constitute the basis on which subsequently to define more detailed obligations in the implementing directive, such as for instance the nature and content of the information and reporting requirements concerning complex products between eligible counterparties suggested above.

198 Amending Article 24 of Directive 2004/39/EC

199 Article 35 (2), first subparagraph, and Article 36 second subparagraph of Directive 2006/73/EC.

200 Amending Annex II, Section I(3) of Directive 2004/39/EC

**per se in order to exclude local public authorities/municipalities?
Please explain the reasons for your views.**

(106) Do you consider that the current presumption covering the professional clients' knowledge and experience, for the purpose of the appropriateness and suitability test, could be retained? Please explain the reasons for your views.

7.2.6. Liability of firms providing services

While investment firms are subject to possible administrative sanctions by the competent authorities if they infringe MiFID rules, the directive does not deal with the liability of firms towards clients in cases where infringement of MiFID rules causes damage. Thus, the conditions for such civil liability vary according to Member States' civil legal orders and may sometimes be difficult to establish.

The Commission services regularly receive complaints, especially from retail investors, claiming that firms have violated conduct of business obligations. Introducing a principle of civil liability of investment services providers would be essential for ensuring an equal level of investor protection in the EU.

Such a principle, could be included in the framework directive and would enable clients to claim damages against investment firms infringing MiFID rules, particularly in areas concerning the relationship between firms and clients and where specific obligations towards the client are foreseen. The following areas could be covered: information requirements,²⁰¹ suitability and appropriateness test,²⁰² reporting requirements,²⁰³ best execution²⁰⁴ and client order handling.²⁰⁵

(107) What is your opinion on introducing a principle of civil liability applicable to investment firms? Please explain the reasons for your views.

(108) What is your opinion of the following list of areas to be covered: information and reporting to clients, suitability and appropriateness test, best execution, client order handling? Please explain the reasons for your views.

7.2.7. Execution quality and best execution

The best execution obligation,²⁰⁶ the availability of data on execution quality, and the pre- and post-trade transparency requirements addressed in Section 3 above are closely linked. A well functioning pre- and post trade transparency regime provides a critical part of the information needed to assess execution quality and hence also to review firms' execution arrangements. Nevertheless, other information can also be relevant. This

201 Article 19(3) of Directive 2004/39/EC

202 Article 19(4) and (5) of Directive 2004/39/EC

203 Article 19(8) of Directive 2004/39/EC

204 Article 21(5) of Directive 2004/39/EC

205 Article 22(1) of Directive 2004/39/EC

206 Article 21 of Directive 2004/39/EC and Articles 44-46 of implementing Directive 2006/73/EC

concerns for instance the number of orders cancelled prior to execution or the speed of execution.

The Commission services consider that an obligation could be introduced in the framework directive on trading venues to produce data on execution quality; in line with the proposal to extend pre- and post-trade requirements beyond shares, data on execution quality would be published for all financial instruments traded on different types of venues²⁰⁷. The information about execution quality would help firms, together with the measures concerning pre- and post-trade data addressed in Section 3, to improve compliance with best execution obligations.

The Commission services have also received frequent feedback from investors in different Member States concerning the quality of information they receive on the execution policies adopted by firms and the possibility to verify firms' compliance with best execution obligations. In addition to strengthening provisions on civil liability as per the previous section, the Commission services consider that requirements relating to best execution in the implementing directive could be strengthened 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 and at which venue and check that they receive best execution.²⁰⁸

In particular, detailed requirements in the implementing directive could also cover professional clients and firms carrying out portfolio management and reception and transmission of orders. Further, execution policies could clearly make a distinction based on types of instruments, clients and orders. Firms using internal matching systems could clearly disclose and explain how best execution is achieved, and firms executing orders on a single execution venue could provide an explanation for this. Finally, a template for policies to facilitate disclosure to clients could be introduced.

Implementing acts could also be envisaged in order to ensure a uniform application of MiFID principles across the EU.

(109) What is your opinion about requesting execution venues to publish data on execution quality concerning financial instruments they trade? What kind of information would be useful for firms executing client orders in order to facilitate compliance with best execution obligations? Please explain the reasons for your views.

(110) What is your opinion of the requirements concerning the content of execution policies and usability of information given to clients should be strengthened? Please explain the reasons for your views.

7.2.8. Dealing on own account and execution of client orders

Dealing on own account by investment firms is listed among the investment services and activities requiring authorisation. The MiFID definition of dealing on own account is very broad since it includes trading against proprietary capital resulting in the conclusion

207 In new provisions in Directive 2004/39/EC and in Section 4, Chapter IV of Regulation 1287/2006

208 In Article 46 of Directive 2006/73/EC

of transactions in financial instruments.²⁰⁹ On the other hand, the exemption regime in MiFID narrows significantly the coverage of this activity by excluding persons who do not provide any investment service or activities other than dealing on own account, unless they are market makers or deal on own account outside a regulated market or an MTF on an organised, frequent and systematic basis.²¹⁰

Experience shows that practice and supervision in Member States differ on how MiFID is applied to specific cases of firms dealing on own account and on the scope of this activity. This is particularly the case when firms execute client orders (another investment service which requires authorisation) against their proprietary capital. The Commission services consider that the definition of dealing on own account and the corresponding exemption could be modified to make clear that the exemption applies to persons who do not provide any investment services or activities other than dealing on own account unless they are market makers or deal on own account by executing client orders. Firms dealing on own account by executing client orders would continue to be authorised for the execution of orders on behalf of clients and to be subject to the corresponding obligations towards clients (for instance best execution²¹¹).

Another issue concerning the definition of dealing on own account concerns the treatment under MiFID of orders executed for clients using matched principal (also known as "back to back") trading. Provided the legs of the trades are precisely matched, this method of executing orders can either be considered only as the execution of client orders, or also as dealing on own account, based on the argument that the firm's proprietary capital may be put at risk if one of the matched trades fails.²¹² The classification of this part of executing client orders has potential implications, in terms of, for instance, the applicability of the systematic internaliser regime and the capital treatment under the Capital Adequacy Directive.²¹³

The Commission services consider that it should be clarified that generally under MiFID, the execution of client orders on a matched principal basis should be treated as also involving the activity of dealing on own account.²¹⁴ But this should not affect the treatment under the Capital Adequacy Directive. The potential application of the systematic internaliser regime to such trading is however less clear as in substance a back to back trade involves a trade between two clients (even if technically the firm may interpose itself).

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|---|
| <p>(111) What is your opinion on modifying the exemption regime in order to clarify that firms dealing on own account with clients are fully subject to MiFID requirements? Please explain the reasons for your views.</p> |
| <p>(112) What is your opinion on treating matched principal trades both as</p> |

209 Article 4(1)(6) of Directive 2004/39/EC.

210 Article 2(1)(d) of Directive 2004/39/EC.

211 As established in recital 69 of Directive 2006/73/EC.

212 The definition of "execution of orders on behalf of clients" and "dealing on own account" can be found in Articles 4(1)(5) and 4(1)(6) of Directive 2004/39/EC.

213 Currently article 5(2)(a) of Directive 2006/49/EC provides that a firm does not hold financial instruments on own account if they are precisely matched.

214 In Article 4(1)(6) of Directive 2004/39/EC

execution of client orders and as dealing on own account? Do you agree that this should not affect the treatment of such trading under the Capital Adequacy Directive? How should such trading be treated for the purposes of the systematic internaliser regime? Please explain the reasons for your views.

7.3. Authorisation and organisational requirements

7.3.1. Fit and proper criteria

The framework directive requires persons who effectively direct the business of an investment firm to be of sufficiently good repute and sufficiently experienced as to ensure the sound and prudent management of the investment firm (so called "fit and proper test")²¹⁵. This provision is generic and has led to different application in Member States. The implementing directive regulates the responsibility of senior management in ensuring the compliance of investment firms with their obligations under the MiFID.

Following the Commission services consultation on corporate governance issues²¹⁶, the Commission services consider that this framework could be clarified and strengthened with particular reference to the role of executive and non-executive directors. As to fit and proper criteria, different roles could be mirrored in different professional skills (for instance, non-executive directors should have professional experience in the financial field to enable them to carry out their role and should fulfil independence requirements in relation to the firm where they provide their activity). In addition, the role of supervisors could clearly include the initial and on-going assessment of fitness and propriety of directors.

The Commission services consider that the following modifications in the framework and in the implementing directives could be envisaged:

- 1) fit and proper criteria would clearly apply to all members of the board of directors (both executive and non-executive directors) and not only to persons who effectively direct the business²¹⁷. Fit and proper criteria could include the assessment of time commitment, especially for non-executive members of the board;
- 2) competent authorities would be satisfied, at the moment of the authorisation and in the on-going monitoring of the firms, that all members of the board are and continue to be of sufficiently good repute and sufficiently experienced to ensure the sound and prudent management of the firm and compliance with the applicable rules;
- 3) implementing measures could clarify the details of these requirements in order to adapt them to different roles and functions and ensure their uniform application²¹⁸;

215 Article 9 of Directive 2004/39/EC

216 Green Paper on "Corporate governance in financial institutions and remuneration policies" (COM(2010) 284 final)

217 Article 9 of directive 2004/39/EC

218 New provision in the implementing directive

- 4) the definition of senior management²¹⁹ in the implementing directive would explicitly include executive directors. The supervisory function²²⁰ mentioned in the implementing directive would explicitly include non-executive directors. These specifications would ensure the full involvement of executive and non-executive directors, according to the respective competences, in the firm's compliance with relevant requirements.

(113) What is your opinion on possible MiFID modifications leading to the further strengthening of the fit and proper criteria, the role of directors and the role of supervisors? Please explain the reasons for your view.

7.3.2. Compliance, risk management and internal audit functions

The implementing directive sets the general framework for the establishment and the operation of internal control functions. A prominent role is granted to the compliance function²²¹ which has to monitor that firms implement and maintain policies and procedures to detect and minimize the risk of non-compliance with their obligations under MiFID and to assess the adequacy and effectiveness of such policies and procedures, also in the light of their actual application. A relevant role is also recognized to the risk management function²²² in order to identify risks relating to the firm's activities and set, where appropriate, the level of risk tolerated by the firm. The internal audit function²²³ is required to establish an audit plan to evaluate the overall adequacy of the firm's systems and internal control mechanisms. Senior management receive and assess on a frequent basis, written reports on the matters covered by the different functions. Organizational requirements also include the obligation for firms to establish and maintain procedures for the handling of retail clients' complaints²²⁴.

The Commission services consider that the involvement of board members in the functioning of the three internal functions could be further strengthened. In particular, the Commission services consider that the implementing directive could specify that the three functions should be able to report directly to the board of directors and that the removal of the officers responsible for the internal control functions would be subject to prior approval by the board and should be notified to the supervisor²²⁵.

Furthermore, the Commission services consider that the current framework for the handling of client complaints could be strengthened. The implementing directive could foresee the specific involvement of the compliance function in the procedures established by the firm to handle complaints received from any clients (irrespective of their category). The periodic report from the compliance function could specifically summarize complaints received from clients and their treatment. Based on the assessment of the functioning of internal policies and procedures, including the assessment of the

219 Article 2 (9) of Directive 2006/73/EC

220 Article 9 (4) of Directive 2006/73/EC

221 Article 6 of Directive 2006/73/EC

222 Article 7 of Directive 2006/73/EC

223 Article 8 of Directive 2006/73/EC

224 Article 10 of Directive 2006/73/EC

225 Article 9 of Directive 2006/73/EC

behaviours of personnel in complying with obligations under the directive, the periodic report of the compliance function could also include proposals to address any deficiencies which may have emerged.

(114) What is your opinion on possible MiFID modifications leading to the reinforcing of the requirements attached to the compliance, the risk management and the internal audit function? Please explain the reasons for your view.

7.3.3. Organisational requirements for the launch of products, operations and services

MiFID sets a high level framework for firms' organisational requirements²²⁶. The appropriate design of distribution and sales policies and the adoption of adequate firms' internal controls around products and services development are crucial to avoid detrimental practices toward clients. The Commission services consider that the current organisational requirements in the implementing directive could be specified in order to stress their relevance at the stage when firms design and shape their general policies and decide the products, operations and services that will be offered to retail and professional clients²²⁷; this would be particularly relevant in the case of new products or variations to existing services provided by the firm. The following modifications could be introduced:

- a) require investment firms to run an assessment of the compatibility of the product, service or operation with the characteristics and needs of the clients to whom these products would be offered;²²⁸
- b) strengthen the duty of the compliance function in ensuring that procedures and measures are in place to ensure the product, service or operation complies with all applicable rules including those relating to disclosure, suitability/appropriateness, inducements and proper management of conflicts of interest (including remuneration);²²⁹
- c) ensure as part of the organisational requirements for risk management that the risks to the firm of new products, operations and services are adequately managed;²³⁰
- d) stress testing the products and services as appropriate;²³¹
- e) periodically review the distribution and performance of products and services;²³²
- f) ensure that staff possess the necessary expertise to understand the characteristics and risk of products and services provided and receive the appropriate training when new products are offered²³³; and

226 Articles 13(2) and (3) of Directive 2004/39/EC

227 Amending Section 1, Chapter II of Directive 2006/73/EC

228 Article 5 (1) of Directive 2006/73/EC

229 Article 6 of Directive 2006/73/EC

230 Article 7 of Directive 2006/73/EC

231 Article 5 (1) of Directive 2006/73/EC

232 Article 5(5) of Directive 2006/73/EC

233 Article 5 (1) of Directive 2006/73/EC

- g) ensure that the board of directors, if applicable, or a corresponding governing body has effective control over the aspects mentioned above. To this effect, information about the products and services could be systematically included in compliance reports to senior management and to regulators on request.²³⁴

(115) Do you consider that organisational requirements in the implementing directive could be further detailed in order to specifically cover and address the launch of new products, operations and services? Please explain the reasons for your views.

(116) Do you consider that this would imply modifying the general organisational requirements, the duties of the compliance function, the management of risks, the role of governing body members, the reporting to senior management and possibly to supervisors?

7.3.4. Specific organisational requirements for the provision of the service of portfolio management

The Commission services consider that the specificities of the service of portfolio management²³⁵ could be further taken into account in the context of organisational requirements. The service of portfolio management on a discretionary client-by-client basis requires a specific authorization under MiFID and is subject to the general organizational requirements and conduct of business rules²³⁶. The area of the actual management of portfolios by firms, however, is not covered by any specific provision.

The Commission services consider that the implementing directive²³⁷ could require firms providing portfolio management to formalize and retain documents concerning the definition and implementation of their investment strategies in managing clients' portfolios. Firms would pay special attention to the various strategies and ensure that they fit the profile of the investors over all of the life of the mandate in accordance with suitability requirements²³⁸. They would also have to make sure that they would be able to implement efficiently and consistently these strategies without diverging from the parameters set at the beginning. The general investment policies and various systems and procedures to implement and monitor the managing of the portfolios would be approved and checked on a regular basis by senior management.

(117) Do you consider that specific organisational requirements could address the provision of the service of portfolio management? Please explain the reasons for your views.

234 Article 6 and 9(2) of Directive 2006/73/EC

235 Article 4(1)(9) of Directive 2004/39/EC

236 Articles 13 and 19 of Directive 2004/39/EC

237 Article 5 of directive 2006/73/EC

238 Article 19 (4) of Directive 2004/39/EC.

7.3.5. *Conflicts of interest and sales process*

Conflicts of interest requirements²³⁹ cover a broad range of situations that may occur in the provision of investment services and activities. This also includes the remuneration of sales forces and the structure of incentives for the distribution of financial products.

The Commission services consider that the framework for addressing conflicts of interest within MiFID is still appropriate to prevent failures in the sales process provided that it is consistently applied across Europe. The key element of this framework is the management and the avoidance of conflicts – not just disclosure. While the framework also addresses circumstances in which the disclosure of conflicts of interest might be necessary, this is a measure of last resort and not a means for managing conflicts of interest. For instance, it would be very difficult for a firm which creates strong incentives for its sales staff to sell certain products, e.g. through internal bonus structures, to be able to manage the conflicts of interest thereby created. It is unlikely that such a firm could, in this situation, demonstrate compliance with MiFID.

The Commission services consider that the convergent application of conflicts of interest provision has to be ensured across the Union in order to grant the same level of investor protection in different jurisdictions and the same treatment of intermediaries providing the services. To this end, implementing measures in the area of conflicts of interest would be useful for a consistent application of MiFID principles.

(118) Do you consider that implementing measures are required for a more uniform application of the principles on conflicts of interest?

7.3.6. *Segregation of client assets*

Recent cases where ownership of assets has been in dispute²⁴⁰ as a result of poor rules or practices underline the importance to have strong requirements in this area. Therefore, the Commission services consider appropriate to introduce modifications in the implementing directive²⁴¹ in the following areas.

1. A recital²⁴² currently allows the exclusion of client asset protection rules when full ownership of funds and financial instruments has been transferred to an investment firm to cover any client obligations. The indiscriminate application of such a possibility would jeopardise the effectiveness of segregation of client assets requirements. The Commission services consider that these arrangements would not be allowed, at least when dealing with retail client assets.²⁴³ Member States would also be given the option to exclude title transfer collateral arrangements in the case of professional clients and eligible counterparties and to require that, when such arrangements are allowed, clients receive a specific warning in writing giving appropriate evidence of the risk of these arrangements.

239 Article 13 (3) and 18 of Directive 2004/39/EC

240 For instance, the Lehman Brothers case

241 Section 3, Chapter II of Directive 2006/73/EC

242 Recital 27 of Directive 2004/39/EC

243 We note that the UK Financial Services Authority is consulting on a similar proposal for retail clients assets (CP 10/15 – July 2010).

2. MiFID allows the use of securities financing transactions involving client financial instruments held by the investment firm, subject to clients' express consent.²⁴⁴ The Commission services consider that the implementing directive could require firms, at least for retail client assets, to adopt specific arrangements to ensure that the borrower of client assets (for instance in the case of stock lending activities) provides the appropriate collateral and that the firm monitors the continued appropriateness of such collateral and takes the necessary steps to maintain the balance with the value of client assets.
3. Firms are required to provide retail clients with clear, full and accurate information on the terms of the use of the financial instruments and relevant risk.²⁴⁵ The Commission services consider that the described information is a useful tool irrespective of the type of client and would be consequently extended to all categories of clients in order to increase awareness of the risk of such practices.
4. Investment firms are required to place client funds into accounts opened with a central bank or a credit institution or certain money market funds and, except for central banks, to exercise all due skill, care and diligence in the selection and review of the institutions they choose.²⁴⁶ As a result of the financial crisis, it has emerged that the concentration of client money in group entities may face the risk of contagion when intra-group insolvency occurs. The Commission services consider that diversification in the placement of client funds could be one of the criteria of conducting the due diligence and that implementing acts could be proposed in this area.

- (119) What is your opinion of the prohibition of title transfer collateral arrangements involving retail clients' assets? Please explain the reasons for your views.**
- (120) What is your opinion about Member States be granted the option to extend the prohibition above to the relationship between investment firms and their non retail clients? Please explain the reasons for your views.**
- (121) Do you consider that specific requirements could be introduced to protect retail clients in the case of securities financing transaction involving their financial instruments? Please explain the reasons for your views.**
- (122) Do you consider that information requirements concerning the use of client financial instruments could be extended to any category of clients?**
- (123) What is your opinion about the need to specify due diligence obligations in the choice of entities for the deposit of client funds?**

244 Article 19 of Directive 2006/73/EC

245 Article 32 (7) of Directive 2006/73/EC

246 Article 18 of Directive 2006/73/EC

7.3.7. *Underwriting and placing*

Corporate finance business is covered under different investment and ancillary services in MiFID: underwriting and placing, advice to undertakings, including services related to mergers, services related to underwriting.²⁴⁷ Firms providing the investment service of underwriting and placing need to be authorised and are subject to MiFID requirements.

The most relevant aspects²⁴⁸ emerging from the provision of these services include managing in an appropriate way the process preceding the issue of the new instruments, governing the internal flow of information concerning the offering, ensuring a proper pricing of the securities, ensuring the availability of the necessary information about the new instruments, allocating the securities in a way that respects the interest of the different actors involved, and keeping complete internal records of the entire process.²⁴⁹

Given the specificities surrounding these services more detailed and tailored requirements in the implementing directive might be appropriate. The following options could be considered:

- a) Requiring firms to establish specific organisational arrangements and procedures concerning all the different steps of the underwriting process (preliminary contacts with the issuer, formation of the syndication, pricing of the securities, actual issue of the securities, methods used to mitigate risk) and to keep the relevant records
- b) Introducing specific rules in the implementing directive in order to deal with the allotment process, including conduct of business rules (for instance, information requirements towards issuers and investors concerning procedures and criteria adopted by the firm in distributing the financial instruments; specific recordkeeping obligations which also include the overall allotment of financial instruments in the case of syndications involving different investment firms)
- c) Addressing relevant practices through specific conflicts of interest requirements in order to better capture the peculiarities of underwriting and placing activities. This model has already been followed for conflicts of interests arising in the context of investment research.²⁵⁰

247 Annex I, Section A(6) and (7) – Section B(3) and (6) of Directive 2004/39/EC

248 Detailed practices also differ depending on the types of instruments involved (notably, equity or debt securities)

249 Some specific practices have recently attracted attention. Based on contributions from CESR and market participants, these practices may be described as follows:

- pre-sounding, i.e. discussion between investment firms and potential investors, prior to any public announcements, in order to assess the likely demand for bond issues. These preliminary contacts may lead to certain investors holding inside information;
- inflating of orders and over-marketing of issues. The former consists of the investors overbidding for new securities in order to receive a good allocation of them in the case of oversubscription; the latter indicates an aggressive marketing by the investment firm concerning an inflated order book. Both practices give an altered picture of the demand for an issue;
- shadow book-building, that is testing the interest of investors before the announcement of an issue. This practice would cause the shortening of the official book-building process and would not allow investors to properly evaluate the new issues.

Other issues sometimes mentioned concern the over-pricing, that is an over-estimation of the issue price and, more in general, a pricing which favours issuers rather than investors (or, also, institutional investors rather than issuers) and the unfair treatment of different investors (or categories of investors) in the allotment of the securities.

250 Article 25 of Directive 2006/73/EC

(124) **Do you consider that some aspects of the provision of underwriting and placing could be specified in the implementing legislation? Do you consider that the areas mentioned above (conflicts of interest, general organisational requirements, requirements concerning the allotment process) are the appropriate ones? Please explain the reasons for your views.**

8. FURTHER CONVERGENCE OF THE REGULATORY FRAMEWORK AND OF SUPERVISORY PRACTICES

This section presents suggestions aimed at narrowing or eliminating some options and discretions and increasing the effectiveness of supervision and enforcement, especially in areas not touched upon in the previous sections of this consultation document. They are based both on the principles and proposals of the de Larosière group and the agreement of ECOFIN,²⁵¹ as well as the manifest need to equip competent authorities with specific new powers in the wake of the crisis.

8.1. Options and discretions

8.1.1. Tied agents

Member States may currently allow²⁵² investment firms to use tied agents as a means of offering their services and soliciting business²⁵³. This option has been exercised in most Member States. Based on CESR assessment²⁵⁴, the rules governing tied agents have worked well so far. Thus, the Commission services consider that only a few adjustments to these provisions would be necessary.

In particular:

- a) National discretion of allowing tied agents²⁵⁵ could be abolished and the possibility to use tied agents would be generalised in all Member States.
- b) The possibility for Member States to allow tied agents to handle clients' money and/or financial instruments could be restricted.²⁵⁶ Although this possibility is subject to the tied agent remaining under the full and unconditional responsibility of the investment firm, it may pose undue risks especially when tied agents represent investment firms which are themselves not authorised to hold client money and/or financial instruments. Therefore, tied agents would not be allowed to hold client money or assets.

251 See Report of High-level Group on Financial Supervision in the EU chaired by Jacques de Larosière, 25 February 2009, and Agreed Council conclusions on Strengthening EU Financial Supervision, 10 June 2009.

252 Article 23(1) of Directive 2004/39/EC

253 Tied agents are defined under article 4 (1) (25) of Directive 2004/39/EC

254 CESR/10-859, p. 33

255 Article 23(1) of Directive 2004/39/EC

256 Article 23(2) of Directive 2004/39/EC

- c) Tied agents would be treated as a branch²⁵⁷ independently of whether the investment firm operates any other branches on the territory of the host Member State. This would ensure their appropriate and consistent supervision across the EU.
- d) Where an investment firm intends to use tied agents in providing services cross border, the current MiFID provisions allow, but do not prescribe, the transmission of the identity of tied agents from the home to the host competent authority. The host supervisor has the option, but not the obligation, of publishing this information.²⁵⁸ For investor protection reasons, it is important to give investors the possibility to check the identity of a tied agent. Therefore, it would be appropriate to make both requirements mandatory.
- e) Finally, the passporting provisions only apply to investment firms which intend to use tied agents. The cross-border activities of credit institutions using tied agents are not regulated under EU legislation, resulting in an unlevel playing field between the two types of institutions providing the same services. In order to ensure sufficient transparency for investors and competent authorities, the provisions on tied agents under articles 31 and 32 of Directive 2004/39/EC could also be applicable to credit institutions.²⁵⁹

- (125) What is your opinion of Member States retaining the option not to allow the use of tied agents?**
- (126) What is your opinion in relation to the prohibition for tied agents to handle clients' assets?**
- (127) What is your opinion of the suggested clarifications and improvements of the requirements concerning the provision of services in other Member States through tied agents?**
- (128) Do you consider that the tied agents regime require any major regulatory modifications? Please explain the reasons for your views.**

8.1.2. *Telephone and electronic recording*²⁶⁰

MiFID leaves to Member States the possibility to require firms to record telephone and electronic communications involving client orders. Most Member States have used this option. However, the wide discretion introduced by MiFID has led to different approaches between Member States, ranging from the lack of any obligations to very detailed rules in this area.

²⁵⁷ Article 32 (2), second paragraph, of Directive 2004/39/EC

²⁵⁸ Article 31 (2) of Directive 2004/39/EC

²⁵⁹ This would imply qualifying the exclusions in Article 1(2) of Directive 2004/39/EC as regards Articles 31 and 32 by stating that the exclusions do not apply in the case of tied agents.

²⁶⁰ Article 51(4) of Directive 2006/73/EC

The Commission services consider that a common mandatory regime for telephone and electronic recording across the EU would be beneficial, in view of improving the detection of abusive and manipulative behaviours affecting the integrity of the markets. Such a regime would notably benefit supervisors but also firms (who would be able to demonstrate more easily their behaviour). This requirement should be in accordance with EU data protection rules.²⁶¹

However, it is important to acknowledge the existence of specificities in supervisory techniques between competent authorities and the considerable technical details involved in this area. Therefore, on the one hand, a degree of discretion could be left for Member States to impose requirements additional to those under the common pan-EU mandatory regime and, on the other, implementing measures could be adopted to specify the details associated with the pan-EU requirements, again in accordance with the EU data protection legal framework.

In this context, the Commission services consider it necessary to introduce an obligation to record client orders covering the services of receipt and transmission of orders and execution of orders and transactions concluded when dealing on own account in all financial instruments. Member States would be allowed to extend the obligation to other services (notably, portfolio management). It would apply to all forms of telephone conversation and electronic communications. Implementing measures could clarify the details concerning different technological means. Concerning the retention period, the Commission services consider a minimum retention period of 3 years, while leaving the possibility to Member States to foresee a longer period.

- (129) Do you consider that a common regulatory framework for telephone and electronic recording, which should comply with EU data protection legal provisions, could be introduced at EU level? Please explain the reasons for your views.**
- (130) If it is introduced do you consider that it could cover at least the services of reception and transmission of orders, execution of orders and dealing on own account? Please explain the reasons for your views.**
- (131) Do you consider that the obligation could apply to all forms of telephone conversation and electronic communications? Please explain the reasons for your views.**
- (132) Do you consider that the relevant records could be kept at least for 3 years? Please explain the reasons for your views.**

8.1.3. Additional requirements on investment firms in exceptional cases

MiFID has introduced the general principle that firms are subject to home country authorisation, supervision and enforcement, even when they provide services in other Member States.²⁶² At the national level however, Member States may adopt additional

261 As established in Directives 95/46/EC and 2002/58/EC

262 The only exception to that principle is foreseen in the case of branches established in other Member States; in that case the host supervisor is competent for supervising the compliance of the branch with MiFID conduct of business obligations.

requirements on investment firms in "exceptional cases [...] to address specific risks to investor protection or to market integrity that are not adequately addressed by the Directive".²⁶³

Member States have made relatively little use of this option to date.²⁶⁴ This might be because of the difficulty of fulfilling the conditions of Article 4 or the adequacy and sufficient flexibility of the current relevant provisions of MiFID.

The review of the provision has to take into account the need to ensure the highest possible standard of investor protection, the effects of additional requirements on cross-border provision of services and on the competitiveness of EU firms, as well as of the objective of creating a single EU rulebook.

The Commission services consider that a possible way forward would be to abolish Article 4, which has proven difficult to apply, in order for MiFID to be subject only to the general principles on the transposition of directives.²⁶⁵ Moreover, the Commission services consider appropriate to introduce the on-going obligation for Member States to communicate to the Commission any addition or modification in the text of the national provisions in the field covered by MiFID.²⁶⁶ This would modify the current obligation which may be interpreted as only applying to the initial adoption of those national provisions.²⁶⁷

(133) What is your opinion on the abolition of Article 4 of the MiFID implementing directive and the introduction of an on-going obligation for Member States to communicate to the Commission any addition or modification in national provisions in the field covered by MiFID? Please explain the reasons for your views.

8.2. Supervisory powers and sanctions

The Commission services consider that increasing the effectiveness of supervision and enforcement could require:

- a) Enhancing the powers of competent authorities to investigate in the area of securities;
- b) Introducing effective and deterrent sanctions;

These modifications would have to be in line with the overall powers and competences of regulators, and especially with those under the Market Abuse Directive.

²⁶³ Article 4 of Directive 2006/73/EC

²⁶⁴ So far, only France, Ireland and the UK have made use of this possibility. The received notifications can be found on the Commission website: http://ec.europa.eu/internal_market/securities/isd/mifid_implementation_en.htm

²⁶⁵ This would entail that Member States should fulfil the objectives of MiFID and could adopt additional measures only where these measures do not contravene the letter or spirit of MiFID or of EU law in general.

²⁶⁶ The existing notifications under Article 4 of Directive 2006/73/EC would be confirmed through a specific grandfathering clause.

²⁶⁷ Article 53 (4) of Directive 2006/73/EC

8.2.1. Powers of Competent Authorities

MiFID already includes a substantial set of powers that Member States have to make available to competent authorities²⁶⁸ (Article 50 of MiFID). This includes for instance the power to carry out on-site inspections and to request the freezing and/or the sequestration of assets. The exercise of the supervisory powers has to respect fundamental rights recognised in the EU Charter of Fundamental Rights and EU law establishing the legal framework on the protection of these fundamental rights, such as EU data protection law.

In the view of the Commission services, competent authorities could have the additional power, according to national rules, to ask a judicial authority authorisation to enter private premises and to seize documents relevant for the enforcement action.

8.2.2. Sanctions (definition, amounts, publication)

The Commission's work-programme includes the adoption of a communication on sanctions in the fields of securities, the banking sector and the insurance sector by the end of the year. In this general context the review of the MiFID is of particular importance. The approach of the sanctions regime in MiFID is to achieve the result that sanctions for violation of MiFID rules adopted by Member States are sufficiently severe and they deter those who may violate MiFID requirements from doing so. Sanctions should therefore be proportionate to the gravity of the infringement and should be consistently applied.

MiFID requires Member States to ensure that it is possible to impose administrative measures or sanctions that are effective, proportionate and dissuasive. Some differences and lack of convergence across the EU, in terms of the administrative and criminal sanctions available for MiFID infringements as well as the application of those sanctions, appear from a CESR report²⁶⁹. Sanctions seem to vary widely across Member States and in some instances are simply too weak in some Member States. This could lead to the risk of weak enforcement and even regulatory arbitrage. The Commission services consider that the MiFID regulatory framework could possibly specify the existing provisions on administrative sanctions.²⁷⁰ In particular Member States could ensure that:

- a) Appropriate administrative measures would mean decisions which have at least the effect of putting an end to a breach of the provisions of the national measures implementing MiFID and/or eliminating its effect. Such administrative measures would include at least: injunctions to put an end to an infringement, temporary prohibition of an activity, suspension or replacement of members of the management or supervisory bodies or of the bodies as such, and the possibility of issuing public notices on the website of competent authorities.
- b) Appropriate administrative sanctions would mean decisions which have the effect of acting as a deterrent against the breach of the provisions of the national

268 Article 50 of Directive 2004/39/EC

269 CESR "Report on the mapping of supervisory powers, supervisory practices, administrative and criminal sanctioning regimes of Member States in relation to the Markets in Financial Instruments Directive (MiFID).", February 2009.

270 In Article 51 of Directive 2004/39/EC

measures implementing MiFID, in particular administrative fines and periodic penalty payments.

- c) A sufficient minimum amount for administrative fines would be established. Where a maximum level of sanctions is provided for in legislation, it would be sufficiently high to guarantee deterrence.

Moreover, the Commission services are considering whether appropriate whistleblowing mechanisms should be established to create incentives to report or tip off infringements to the competent authorities and to protect persons who provide such information. For example, the cooperation of persons involved in the violation could be taken into account in the form of more lenient sanctioning. Competent authorities could have the power to reduce, or not to apply, any sanctions to persons materially cooperating in the enforcement action.

In addition, the Commission services are considering whether Member States should ensure that the most serious infringements (such as the provision of investment services without having been authorised or obtaining the authorisation by making false statements) could be punishable by effective, proportionate and dissuasive criminal sanctions.

The Commission services consider that the competent authority could be obliged to disclose to the public, at least on its website, every measure or sanction that would be imposed for infringement of the provisions adopted in the implementation of MiFID, except in certain narrowly defined cases. This would enhance the current requirement, where the disclosure of the sanction is a mere option for competent authorities.

- (134) Do you consider that appropriate administrative measures should have at least the effect of putting an end to a breach of the provisions of the national measures implementing MiFID and/or eliminating its effect? How the deterrent effect of administrative fines and periodic penalty payments can be enhanced? Please explain the reasons for your views.**
- (135) What is your opinion on the deterrent effects of effective, proportionate and dissuasive criminal sanctions for the most serious infringements? Please explain the reasons for your views.**
- (136) What are the benefits of the possible introduction of whistleblowing programs? Please explain the reasons for your views.**
- (137) Do you think that the competent authorities should be obliged to disclose to the public every measure or sanction that would be imposed for infringement of the provisions adopted in the implementation of MiFID? Please explain the reasons for your views.**

8.3. Access of third country firms to EU markets

Access of third country firms to EU markets is not harmonised under the MiFID but is left to the discretion of Member States, subject to their general obligations under Community law and relevant international obligations, and provided that national provisions do not result in treatment more favourable than that given to European firms.

In practice, this means that third country firms must be subject to a regulatory regime which is at least equivalent to that offered by the MiFID.²⁷¹

In addition, the Commission can ask the Council for a mandate for negotiation with third countries in order to obtain, in those countries, comparable competitive opportunities for EU firms.²⁷² Moreover, MiFID allows the Commission to adopt measures requiring competent authorities to limit or suspend authorisation of third-country firms where third countries do not extend the same treatment to European firms as they do to domestic investment firms.²⁷³

The Commission is also required to publish a list of 'equivalent third-country markets' for the purposes of the 'execution-only' regime.²⁷⁴ This is effectively a concessionary regime that can disapply the appropriateness test for transactions initiated by clients in 'non-complex' instruments.²⁷⁵ Under MiFID, a third country market would be considered as equivalent to a regulated market if it complies with equivalent requirements to those established under Title III of the framework directive (regulated markets).

Given the current interrelationship of financial markets and its global nature as demonstrated by the consequences of the financial turmoil and the effects in EU markets of malpractices and/or negligence by actors based in third countries (e.g. Madoff and Lehman cases), the Commission services consider it necessary to develop at EU level a workable regime for the access of third country investment firms and market operators to EU financial markets in order to create a real level playing field for all financial services actors in the EU territory.

Therefore, it is suggested to introduce a mechanism by which access to the EU could be granted to investment firms and markets authorised and established in other jurisdictions subject to a strict equivalence regime. To this effect, the framework Directive could be modified²⁷⁶ to introduce the principle of exemptive relief for investment firms and market operators based in jurisdictions with equivalent regulatory regimes applicable to markets in financial instruments, as regards areas covered for instance in the EU by MiFID, MAD, the Prospectus Directive²⁷⁷ and Transparency Directive²⁷⁸.

Moreover, the framework directive could grant the Commission the power to define via implementing measures the precise criteria and parameters which a third country regime must fulfil in order to be considered equivalent. This could involve, for example, requirements for authorisation for investment firms or market operators, organisational

271 Recital 28 of MiFID states that branches of investment firms authorised in third countries should not enjoy the freedom to provide services or the right of establishment in Member States other than those in which they are established.

272 Article 15(2) of Directive 2004/39/EC

273 Article 15(3) second subparagraph of Directive 2004/39/EC

274 Article 19(6) of Directive 2004/39/EC

275 See section 7.2.1 above

276 Article 15 of Directive 2004/39/EC

277 Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC (OJ L 345, 31.12.2003, p. 64)

278 Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC (OJ L 390 of 31.12.2004, p.38)

and conduct of business requirements, powers of competent authorities, and applicable rules against market abuse including disclosure requirements for issuers. The conclusion of Memoranda of Understanding (MoUs) with third country supervisory authorities should also be envisaged.

This provision could also grant the Commission the power to specify via implementing measures the process through which the assessment of equivalence of each individual third country jurisdiction would be made.

Finally, each assessment of equivalence would be made as a separate implementing measure necessary to implement exemptive relief.

Given the fact that third country firms providing services in the EU would be subject to the EU client-facing obligations, notably in the areas of conduct of business rules (information requirements, appropriateness and suitability, reporting obligations), client classification, best execution, client order handling and segregation of clients assets, it is considered that at a first stage the access mechanism could be applied only for non-retail investors.

- (138) **In your opinion, is it necessary to introduce a third country regime in MiFID based on the principle of exemptive relief for equivalent jurisdictions? What is your opinion on the suggested equivalence mechanism?**
- (139) **In your opinion, which conditions and parameters in terms of applicable regulation and enforcement in a third country should inform the assessment of equivalence? Please be specific.**
- (140) **What is your opinion concerning the access to investment firms and market operators only for non-retail business?**
- (141)

9. REINFORCEMENT OF SUPERVISORY POWERS IN KEY AREAS

9.1. Ban on specific activities, products or practices

Recently, there have been various calls to subject complex products such as certain types of structured products, to stricter regulatory scrutiny. In this context, the Commission services consider necessary to introduce, in clearly specified conditions and subject to a clear procedure, the possibility for the Commission to ban the provision of investment services and the carrying out of investment activities in certain financial instruments.

The criteria for such a ban, to be enshrined in the framework directive, could be broad ranging but precise in nature. This could apply if:

- a) Investment services are provided in a way which gives rise to significant and sustained investor protection concerns; or

- b) There is a product or activity threatening the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system.

In view of the potentially significant consequences for market participants and businesses, the Commission services consider that any such ban would, except in extraordinary circumstances, require consultation, be based on appropriate evidence of risks and require cost/benefit analysis.

Second, national regulators would be given the power to temporarily ban or restrict the trading or the distribution of a product by one or more investment firms or the provision of an activity in case of exceptional adverse developments which constitute a serious threat to financial stability or to market confidence in a Member State or the European Union. In addition, when a specific OTC derivative should be cleared on systemic risk grounds but no CCP would offer to clear it, competent authorities could ban trading in that OTC derivative pending a CCP offering clearing in the instrument. The Commission services consider that the exercise of this power could be pre-notified to and coordinated through ESMA.²⁷⁹

Third, the Commission services consider that when a competent authority or competent authorities have not taken measures to address a threat to the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system arising from the distribution of a product or the provision of an activity, or the measures that have been taken do not sufficiently address the threat, it would be necessary to create the relevant mechanism at Union level to ban in a temporary manner the distribution of such product or the provision of such activity²⁸⁰.

- (142) What is your opinion on the possibility to ban products, practices or operations that raise significant investor protection concerns, generate market disorder or create serious systemic risk? Please explain the reasons for your views.**
- (143) For example, could trading in OTC derivatives which competent authorities determine should be cleared on systemic risk grounds, but which no CCP offers to clear, be banned pending a CCP offering clearing in the instrument? Please explain the reasons for your views.**
- (144) Are there other specific products which could face greater regulatory scrutiny? Please explain the reasons for your views.**

²⁷⁹ This would add to the existing power of regulators to require the removal of trading of a financial instrument from trading under Article 50(2)(g) and (k) of Directive 2004/39/EC.

²⁸⁰ Article 9(5) of Regulation (EU) No .../... of the European Parliament and of the Council establishing a European Supervisory Authority (European Securities and Markets Authority) amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC could be taken into consideration

9.2. Stronger oversight of positions in derivatives, including commodity derivatives

Currently, the manner in which competent authorities monitor and supervise positions in derivatives on trading venues and OTC varies between EU jurisdictions. This can take the form of hard position limits or an ad hoc position management approach.²⁸¹

As a result of the significant growth in the size of derivative markets in recent years, there is a case for stronger oversight of positions in derivatives, especially commodity derivatives (as mentioned in Section 5 above), as well as increased harmonisation in order to avoid any regulatory arbitrage and ensuring a level playing field within the EU. In addition the European Parliament has recently stated that regulators should have harmonised powers to set position limits to reduce systemic risk and combat disorderly trading, especially for certain categories of derivatives²⁸² echoing various calls to introduce positions limits to curb "financial speculation" in commodity derivatives markets.

In light of the above, the Commission services consider that:

- a) The framework directive could be amended²⁸³ to bestow competent authorities with effective and harmonised powers to intervene at any stage during the life of a derivative contract. This heightened form of position management would involve competent authorities being able to request any natural or legal person entering into a derivative transaction to:
 - Provide a full explanation for the position;
 - Provide all relevant documentation, including evidence of the purpose of the position as hedging or otherwise;
 - Reduce the size of the position in the interests of the orderly functioning of markets, investor protection, or market integrity.
- b) The amendment would also introduce greater coordination at EU level in the requests for explanations and relevant documentation by competent authorities in order to ensure a consistent approach in the application of these powers.

281 Exchanges also have the possibility when needed to incorporate flexible position management powers into their rules or adopt position limits. The latter are mostly recognised as a potential tool for combating market manipulation in certain types of financial instruments. Such limits already exist in a number of jurisdictions for some exchange traded derivatives in order to prevent market manipulation and manage settlement risk (e.g. especially for physically settled commodity derivative contracts).

282 European Parliament resolution of 15 June 2010 on derivatives markets: future policy actions (A7-0187/2010) calls on the Commission to develop measures to ensure that regulators are able to set position limits to counter disproportionate price movements and speculative bubbles, as well as to investigate the use of position limits as a dynamic tool to combat market manipulation, most particularly at the point when a contract is approaching expiry. It also requests the Commission to consider rules relating to the banning of purely speculative trading in commodities and agricultural products, and the imposition of strict position limits especially with regard to their possible impact on the price of essential food commodities in developing countries and greenhouse gas emission allowances.

283 With a new article in Title IV of Directive 2004/39/EC

- c) As part of this heightened position management, and when necessary for tackling some or all of these threats or for addressing risks to the overall stability or delivery and settlement arrangements of physical commodity markets, the framework directive could be amended²⁸⁴ to allow for the adoption of implementing measures setting ex-ante position limits both for derivative contracts traded on exchange and OTC. These limits would take account of market developments, the specificities of the different types of derivative products and, in the case of commodity derivatives, the evolution of the physical market of the relevant commodity.²⁸⁵

New implementing measures could further define the details of when the powers to propose position limits may be triggered. For example, these could be triggered when conditions in a given market in terms of liquidity or market concentration jeopardise market efficiency or integrity.

(145) If regulators are given harmonised and effective powers to intervene during the life of any derivative contract in the MiFID framework directive do you consider that they could be given the powers to adopt hard position limits for some or all types of derivative contracts whether they are traded on exchange or OTC? Please explain the reasons for your views.

(146) What is your opinion of using position limits as an efficient tool for some or all types of derivative contracts in view of any or all of the following objectives: (i) to combat market manipulation; (ii) to reduce systemic risk; (iii) to prevent disorderly markets and developments detrimental to investors; (iv) to safeguard the stability and delivery and settlement arrangements of physical commodity markets. Please explain the reasons for your views.

(147) Are there some types of derivatives or market conditions which are more prone to market manipulation and/or disorderly markets? If yes, please justify and provide evidence to support your argument.

(148) How could the above position limits be applied by regulators:

- (a) To certain categories of market participants (e.g. some or all types of financial participants or investment vehicles)?**
- (b) To some types of activities (e.g. hedging versus non-hedging)?**
- (c) To the aggregate open interest/notional amount of a market?**

284 In the new title on derivatives in Directive 2004/39/EC

285 These powers should also be seen together with the future legal framework on short selling and the emergency powers that should be granted to regulators to temporarily restrict or ban short selling and credit default swaps though the latter powers only apply in case of exceptional adverse developments which constitute a serious threat to financial stability or to market confidence in a Member State or the EU.