HOUSE OF LORDS

European Union Committee

2nd Report of Session 2012–13

MiFID II: Getting it Right for the City and EU Financial Services Industry

HL Paper 28

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SUMMARY

The original Markets in Financial Instruments Directive (MiFID I), which came into effect in November 2007, aimed to increase the competitiveness of EU financial markets and to facilitate competition between traditional exchanges and alternative venues.

The European Commission has brought forward proposals, known as MiFID II, to reform and extend this regime. This is a complex and significant legislative package that seeks to regulate hitherto less regulated markets in line with G20 commitments. We conclude that a review of MiFID I was necessary, and that some of the Commission's proposals are based on sound principles. Nevertheless, the proposal contains fundamental flaws which need to be corrected as a matter of urgency if serious damage to the EU financial services industry is to be avoided.

Notably, the proposals in relation to third country access are ill-conceived. There is a risk that, if introduced, the provisions could lock third country firms out of the EU markets, which would have an extremely damaging effect on European financial markets, including the City of London. Given that global financial markets are independent of geography, it will also be wholly impractical.

We also fear that an unsophisticated advance to greater transparency could undermine the liquidity and innovation of these markets. Thus on pre-trade transparency, we understand the thinking behind the Commission's proposals, but it is important to acknowledge the markedly different characteristics of each sector of the market, in particular in terms of their liquidity. A one-size-fits-all approach to pre-trade transparency must be avoided. There could be serious repercussions for the entire EU financial services industry were the leading position of the UK within the global financial sector to be undermined because of this approach. It would also have a negative impact on innovation.

There is considerable uncertainty regarding the implications of the proposals for a new category of Organised Trading Facilities (OTFs), aimed at ensuring that all organised trading is conducted on regulated trading venues, and in the proposal to increase regulation of algorithmic and high-frequency trading. The proposals on investor protection and corporate governance are also flawed.

We conclude that the MiFID II proposals have been rushed, and risk creating confusion rather than providing clarity in terms of the regulatory framework for investment. It is more important to get the proposals right than to get them passed quickly. Given the potential implications both for the UK financial markets and for the EU financial sector as a whole, we urge the UK Government, in liaison with the Commission, the Council, and, in the context of its important co-decision powers, the European Parliament, to play their full part in the negotiations on these important proposals.

MiFID II: Getting it Right for the City and EU Financial Services Industry

CHAPTER 1: INTRODUCTION

Background

1. This report examines the European Commission's proposal for a Regulation and a Directive on markets in financial instruments, commonly referred to as MiFID II.[1] The proposal was published in October 2011, following a review of the original Markets in Financial Instruments Directive (MiFID I), in force since November 2007.

2. MiFID is the successor to the Investment Services Directive of 1993 and is the foundation of the EU regulatory framework for investment firms. These firms encompass a wide range of activity such as global investment banks trading complex securities, fund managers investing pension funds, stock-broking firms and small high street financial advisers providing financial advice to the general public. The Commission's objectives in terms of MiFID are to open up trading in securities to competition so as to reduce transaction costs for investors, to apply equivalent regulatory rules to different market models which perform similar functions and to enhance, standardise and harmonise investor protection across the EU. These objectives give effect to the broader EU Treaty objective of creating a single market in financial services in the EU. MiFID II responds to deficiencies in the MiFID I regime exposed by the financial crisis. It focuses in particular on addressing problems that have arisen from the expansion in over-the-counter (OTC) trading in comparison with trading on exchanges and the related issue of transparency of such trading. MiFID II carries fundamental implications for the nature and shape of financial markets by shifting trading from the more opaque OTC market to more transparent organised markets.

3. In order to aid our scrutiny of this important and complex legislative proposal, we invited a number of practitioners and experts in the operation of financial markets to give oral evidence to the Committee:

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1 "MiFID" stands for Markets in Financial Instruments Directive, 2004/39/EC. Throughout this report, "MiFID II" should be taken to refer to the combined package of directive and regulation.

- Chris Bates, Partner, Clifford Chance
- Christian Krohn, Managing Director, Equities and Prime Services, Association for Financial Markets in Europe (AFME)
- Guy Sears, Director, Wholesale, Investment Management Association (IMA)
- Thierry Philipponnat, Secretary General, Finance Watch
- Dr Kay Swinburne MEP, Member of the European Parliament Economic and Monetary Affairs Committee
- Professor Niamh Moloney, Department of Law, London School of Economics
- Professor Emilios Avgouleas, Chair in International Banking, Law and Finance, University of Edinburgh.

We were also assisted in our work by Professor Iain MacNeil, Alexander Stone Chair of Commercial Law, University of Glasgow, who acted as Specialist Adviser for this short inquiry. We are grateful to them all for their assistance. The Glossary to the report defines a number of the technical terms used in relation to MiFID II. **We make this report to the House for debate.**

Is MiFID II necessary?

4. MiFID I established a regulatory framework for the provision of investment services (such as brokerage, advice, dealing, portfolio management and underwriting) by banks and investment firms and for the operation of regulated markets by market operators. It also established the powers and duties of national competent authorities (such as the UK's Financial Services Authority (FSA)) in relation to these activities. The overarching objective was to further the integration, competitiveness and efficiency of EU financial markets, and specifically to abolish the requirement for all trading in financial instruments to take place on specified exchanges, thereby enabling EU-wide competition between traditional exchanges and alternative venues.[2]

5. Although the Commission argues that MiFID I has been successful in encouraging greater competition between venues in the trading of financial instruments, and more choice for investors, it cites a number of problems that have emerged:[3]

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2 COM (2011) 652 final, p. 2.

3 Ibid, p. 3.

- The benefits of increased competition have not flowed equally to all market participants and have not always been passed on to investors.
- Market fragmentation has made the trading environment more complex, with the result that investors and regulators find it more difficult to observe and monitor trading in financial instruments across multiple trading venues.
- Market and technological developments have outpaced various provisions in MiFID I.
- The financial crisis has exposed weaknesses in the regulation of instruments other than shares, traded mostly between professional investors. That assessment follows the approach previously adopted by the Financial Stability Forum which commented in the early phase of the financial crisis that "weaknesses in public disclosures by financial institutions have damaged market confidence during the turmoil. Public disclosures that were required of financial institutions did not always make clear the type and magnitude of risks associated with their on-and off-balance sheet exposures. There were also shortcomings in the other information firms provided about market and credit risk exposures, particularly as these related to structured products. Where information was disclosed, it was often not done in an easily accessible or usable way."[4]
- The growing complexity in financial instruments underlines the importance of high levels of investor protection.

6. Alongside the perceived need to address these problems, the Commission views the proposal as:[5]
   - An essential vehicle for delivering on the September 2009 G20 commitment to tackle the less regulated and more opaque parts of the financial system by the end of 2012. MiFID II addresses the commitment to move trading in standardised derivatives contracts on exchange with a view to improving transparency for investors and regulators.[6] It also extends transparency requirements so as to improve the operation of non-equity markets and enhance the capacity of regulators to supervise market conduct.

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4 Financial Stability Forum, 'Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience' (April 2008).

5 COM (2011) 652 final, op. cit., pp. 3–4.

6 The G20 commitment to require clearing of designated derivatives through a central counterparty is addressed by the European Market Infrastructure Regulation (EMIR).

- An opportunity to contribute to the establishment of a single rulebook for EU financial markets.
- Meeting the requirement for a review of MiFID I as set out in Article 65 of the original Directive.[7]

7. We asked our witnesses whether MiFID II was necessary. Chris Bates and Dr Swinburne regarded it as inevitable in light of the requirement in the Directive and the G20 commitment.[8] Dr Swinburne also stressed that the major technological advancements and developments since MiFID I needed to be addressed.[9] Christian Krohn argued that it was necessary in light of problems such as the fragmentation of data relating to trading, as well as the renewed focus on financial stability since the financial crisis erupted.[10] Guy Sears told us that the magnitude of the task of breaking up the national domination of exchanges that MiFID I entailed meant that there was a lot of "unfinished business" that needed to be addressed.[11]

BOX 1

Timetable for the implementation of MiFID II[12]

December 2010—European Commission issued initial consultation on revising MiFID.

February 2011—UK submitted consultation response to the European Commission.

October 2011—European Commission published proposals for a revised Markets in Financial Instruments Directive and a Markets in Financial Instruments Regulation (MiFID II).

November 2011–present—The proposals are now with the European Parliament and the Council of Ministers for discussion and final adoption of the text.

Late 2012—Expected agreement of the final Level I measures.

2015—Implementation of MiFID II is not expected until at least 2015.

8. Notwithstanding this consensus that further steps were needed, there was considerable concern about the timing of the legislation, and in particular the

7 Dr Swinburne, Q 16.
8 QQ 1, 16.
9 Q 16.
10 Q 1.
11 Ibid.
12 See http://www.fsa.gov.uk/about/what/international/mifid/markets/timetable.

desire to meet the G20 commitment to tackle less regulated and more opaque parts of the financial system by the end of 2012 (See Box 1 above). Guy Sears told us that the timing of the G20 commitment was "unfortunate" because it "advanced the MiFID review and made people feel that they had to get on with it".[13] While Professor Moloney thought that MiFID II had emerged from "a pretty sophisticated process" of engagement and consultation, she too thought that the timing was "ambitious", and that it was impractical to expect the Council and Parliament to agree a common position in the immediate future. She told us that, since the crisis broke, various pieces of legislation have been rushed, causing confusion. In her view, it would be a mistake to rush MiFID II because it was not "crisis-era legislation" necessary to rescue the financial system.[14] Dr Swinburne stressed the complexity of the legislation when she told us that, as of 29 May, 2,145 amendments had been submitted by MEPs.[15] In the light of such complexity, it is important that the Government consult with the financial sector as to the operational implications of the proposal. We also observe that there is a tendency for greater complexity to increase the likelihood of regulatory arbitrage.

9. **We agree with our witnesses that a review of MiFID I was necessary, not least because of the technological advances that have taken place since it came into force. Nevertheless, we are deeply concerned at the speed with which MiFID II has been brought forward. With a package of the size, complexity and importance of MiFID II, it is more important to get the legislation right than to get it passed quickly. The consequences of poorly drafted legislation could be damaging for the EU financial sector, and for the economy as a whole. We urge the UK Government, the Commission, Council and European Parliament to take all steps necessary to ensure that the legislation is fit for purpose before it comes into force. Given the important co-decision powers that the European Parliament now possesses, we particularly urge the Government to ensure that they liaise with and pay due attention to the European Parliament in its consideration of the MiFID II proposals.**

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13 Q 1.

14 QQ 33–34.

15 Q 18.

CHAPTER 2: MIFID II: AN OVERVIEW

10. The main changes set out in MiFID II are outlined in Box 2.

BOX 2

The main changes introduced in MiFID II[16]

- Trading obligation for derivatives: The Commission proposes a requirement for transactions in derivatives that have been declared subject to the trading obligation to be concluded only on regulated markets, Multilateral Trading Facilities (MTFs), Organised Trading Facilities (OTFs) or certain third country venues.
- OTFs: The Commission proposes to introduce a new category of Organised Trading Facilities (OTFs).
- Transparency: The Commission proposes new pre-trade transparency rules for equities, applying to shares, depositary receipts, exchange traded funds, certificates and other similar instruments traded on an MTF or OTF, and the extension of pre-trade transparency requirements to non-equities, specifically bonds and structured products admitted to trading on a regulated market, emission allowances, and derivatives admitted to trading or which are traded on an MTF or OTF.
- Systematic Internalisers (SIs): The Commission proposes extending certain pre-trade transparency and trading requirements to SIs.
- Algorithmic trading: the Commission proposes to introduce certain systems and risk controls, and to require algorithmic trading strategies to be in continuous operation during trading hours and to post firm quotes at competitive prices. These proposals would apply equally to the use of algorithmic trading in the context of high-frequency trading (HFT).
- Third country access: The Commission proposes new rules and requirements for the establishment of branches and the provision of services without a branch by third country firms. The proposal also makes provision for certain reciprocity and equivalence requirements.
- Regulation of commodities derivatives markets: The Commission proposes rules to support liquidity, prevent market abuse and provide for orderly functioning of commodity derivatives markets, including the power to introduce position limits, or alternative arrangements with equivalent effect, on the number of commodity contracts which any

[16] See EMs 15938/11 and 15939/11, paras 8–36.

person can hold. The European Securities and Markets Authority (ESMA) is given certain intervention powers in order to preserve market integrity and orderliness.

- Competition in clearing and trading: Central Counterparties (CCPs) and trading venues are given a right of access to trading venues and CCPs respectively so that access cannot be restricted to parties within the same corporate structures.
- Transaction reporting: The Regulation widens the range of instruments subject to a regulatory transaction reporting obligation from transactions in financial instruments admitted to trading on a regulated market to transactions in all financial instruments traded on a regulated venue.
- Investor protection: The Commission proposes a requirement for investment advisers to make it clear on what basis they provide advice, specifying whether it is on an independent basis and whether it is based on a broad or restricted analysis of the market. Restrictions are placed on commission payments to firms providing investment advice.
- Corporate governance: The Commission proposes certain rules on corporate governance, including restrictions on the holding of multiple directorships, and taking diversity into account.
- Product intervention: National authorities and ESMA are given certain powers to prohibit or restrict the marketing, distribution or sale of certain financial instruments or types of financial activity, if there are significant investor protection concerns, or a serious threat to the orderly functioning and integrity of financial markets or to the stability of the financial system.

11. We asked our witnesses to outline their overall assessment of MiFID II. In Christian Krohn's view, MiFID was one of the most far-reaching and important reform proposals made in the EU since the financial crisis began. AFME supported much of what the Commission is seeking to achieve, but had concerns about some specific proposals.[17] Professor Moloney thought that MiFID II was a broadly good measure, because it "is all about fixing the regulatory perimeter for financial regulation".[18] Yet she feared that it was "moving away from the big debate ... whether financial markets, and in particular equity markets, are doing a good job in moving capital from companies through to investors and vice versa."[19]

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17 Q 1.

18 Q 33.

19 Q 41.

12. Dr Swinburne described the Commission's proposals as a good starting point for deliberation. In her view it was a strong document compared to some previous legislative proposals, although she conceded that it had weaknesses as currently drafted.[20] Dr Swinburne also highlighted the link between MiFID and the European Market Infrastructure Regulation (EMIR) legislative package (previously scrutinised by the Committee),[21] describing them as "two sides of the same coin". The first two elements of the G20 commitment on derivatives transactions, the requirement for all derivative instruments that could be centrally cleared to be treated as such, and the requirement for derivatives trades, wherever they were conducted, to be reported to a central repository, were dealt with in EMIR, which she said was well advanced. MiFID II deals with the third leg of the G20 commitment, namely to move those derivatives instruments that were currently traded over-the-counter on to electronic platforms where appropriate. In comparison, the USA had tackled the G20 commitment in a single piece of legislation, the Dodd-Frank Act. She stressed the need to ensure consistency across the two dossiers to make sure that derivative instruments across the board were treated similarly.[22]

13. We also explored the scope of the proposal. Thierry Philipponnat warned of the danger of making legislation too prescriptive. He told us that "if we try to get into the detail of every single product we can be assured that we will miss the next product invented one or two years down the road." In his view, it was better to ensure that the general framework operated for the benefit of wider society.[23] In Dr Swinburne's view, the balance between the provisions set out in Level 1 and Level 2[24] of the proposal was critical, since getting the details correct in Level 1 would allow the implementation to be more flexible. She had significant doubts about the balance between Level 1 and

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20 Q 18.

21 See EM 13917/10 and Correspondence with Ministers, http://www.parliament.uk/business/committees/committees-a-z/lords-select/eu-economic-and-financial-affairs-and-international-trade-sub-committee-a/scrutiny-work1/parliament-2010/correspondence-with-ministers/. EMIR seeks to address the G20 commitment to require clearing of designated derivatives through a central counterparty. It is expected to enter into force shortly following adoption by the European Parliament in March.

22 Q 17.

23 Q 19.

24 According to the Commission, the MiFID review is based on the "Lamfalussy process" (a four-level regulatory approach recommended by the Lamfalussy Committee on the Regulation of European Securities Markets) and since developed further by EU regulation, whereby at Level 1, the European Parliament and the Council adopt a directive in co-decision which contains framework principles and which empowers the Commission acting at Level 2 to adopt delegated acts. In the preparation of the delegated acts the Commission will consult experts appointed by Member States. At the request of the Commission, ESMA can advise the Commission on the technical details to be included in Level 2 legislation. In addition, Level 1 legislation may empower ESMA to develop draft regulatory or implementing technical standards. See COM (2011) 652 final, footnote 1.

Level 2 in the Commission's proposal, and told us that there were "lots of grey areas left in Level 1". She again made the comparison with EMIR, where much more detail had been set out in Level 1, and expressed the hope that this imbalance could be corrected by amendments from the European Parliament.[25]

14. Both Dr Swinburne and Mr Philipponnat believed that future market developments meant that a MiFID III package was inevitable.[26] Professor Moloney agreed that "the lesson from MiFID I is that whatever the market looks like in five years' time will not be what people thought in drafting MiFID II."[27] Professor Avgouleas told us that regulation will always lag behind market developments, because "clever people will find more ways to trade more effectively, with lower margins and at a profit." He too preferred to build a system based on general principles rather than to regulate the micro-structure of the market.[28]

15. **The view has been expressed to us that the Commission's proposals are a "good starting point" for negotiations. Yet, as we explore in detail in Chapter 3, significant improvements in the text are required before it is implemented, and we welcome the steps taken thus far in the European Parliament and in the Council to address these issues. Broadly speaking, the Commission needs to ensure that MiFID II is consistent with other legislative packages, in particular EMIR. It is also important to ensure that as much clarity as possible is set out in the detail of the Level 1 framework text.**

16. **We further note that there is a tension between a rules-based and a principles-based approach in terms of how to structure the regulatory system in order to anticipate market developments, in seeking to balance flexibility with accountability in the exercise of delegated powers, and in providing sufficient legal certainty to satisfy market participants. In our view, MiFID II does not resolve that tension. Furthermore, there needs to be a recognition that MiFID II, however well it is drafted, will not be the final word in financial market regulation. The single market in financial services is constantly evolving, and it is impossible to predict with any certainty how it will do so in the future. We therefore conclude that further packages of legislative reforms are inevitable.**

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25 Q 19.

26 Q 20.

27 Q 42.

28 Ibid.

CHAPTER 3: ASSESSING MIFID II IN DETAIL

17. We asked our witnesses about the most significant elements of the MiFID II package, as outlined in Box 2 above.

a) Market shape and the case for greater transparency

Organised Trading Facilities (OTFs) and the over-the-counter (OTC) market

18. A central aim of the proposal is to ensure that all organised trading is conducted on regulated trading venues, in order to provide greater transparency and effective regulation. This is in line with the G20 commitment, cited above, that "all standardized OTC derivative contracts should be traded on exchanges or electronic platforms, where appropriate".[29] In addition to the existing categories of regulated markets and Multilateral Trading Facilities (MTFs), the Commission proposes to introduce a new category of Organised Trading Facilities (OTFs). Article 24 of the Regulation sets out a requirement for transactions in derivatives that have been declared subject to the trading obligation to be concluded only on regulated markets, MTFs, OTFs or certain third country venues. Determination of which derivatives should be subject to the trading obligation falls to the European Securities and Markets Authority (ESMA), depending on whether they are assessed to be "sufficiently liquid". With the aim of maintaining operator neutrality, the Commission proposes in Article 20 of the Directive that operators of an OTF must ensure that they have arrangements preventing the execution of client orders in an OTF against the proprietary capital of the operator.[30]

19. Dr Swinburne told us that, as well as seeking to meet the G20 commitment, the OTF proposal was an attempt to address the broker crossing networks[31] in the equity space that had developed post-MiFID I and had given rise to some dark trading.[32] She welcomed the proposal for moving the markets at least part way towards a more sophisticated electronic format. Dr Swinburne predicted that the European Parliament would suggest that OTFs were not

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29 EMs 15938/11 and 15939/11, op. cit., para 67.

30 Ibid., paras 8–10, 17–18. The prohibition would prevent a broker-dealer becoming a counterparty to a transaction submitted to the OTF by a client. Thus, the operator of an OTF cannot act as a principal in the way that a SI or market-maker does by buying from or selling to clients.

31 Professor Moloney described broker crossing networks as similar to Systematic Internalisers, except that when an order to buy a share is placed, the firm simply crosses that order with another client's rather than trade against its own book. She agreed that broker crossing networks had been the big flash-point over the past 18 months. See Q 35.

32 A colloquial term for buying and selling stocks in a manner that avoids or mitigates transparency obligations. See Glossary.

appropriate for equities and seek to ensure that the equities broker crossing network would move on to an MTF or through the existing Systematic Internaliser model. However, she perceived a growing recognition that the OTF category was probably necessary in order to provide flexibility in the non-equities space for trading.[33]

20. Christian Krohn was supportive of the new OTF category on the basis that a platform that brings together third-party buying and selling interests on an organised basis should be subject to consistent regulation. He felt that the Commission's model by and large worked, although he argued that the proposed ban on the operator of the OTF deploying their own capital within an OTF would make the regime unworkable, because it would result in orders not being filled, to the detriment of liquidity and investor choice. Instead, he argued that conflicts-of-interests rules and client-order handling rules in MiFID should be applied to the OTF operator.[34] Guy Sears shared these anxieties, and was concerned that there was insufficient explanation of how the category would work, with too much detail being left to Level 2.[35]

21. Professor Moloney agreed that a ban on 'own capital' was a problem because it was often a way of bringing stability.[36] She thought that discretionary OTFs (i.e. where the platform is actively intervening in orders) that are half way between a broker and an exchange would not deliver a completely neutral mix of third-party orders coming into the market. Whilst the proposal might in theory provide greater transparency, she questioned whether it would in fact create better, more efficient markets.[37] Professor Avgouleas suggested that it would have been simpler and less costly to ensure that all venues where trades take place on exchange are MTFs, rather than introducing a new category.[38]

22. For Chris Bates, the proposal was part of "a big debate about the boundary between organised trading and OTC trading, with the intention being always to squeeze OTC trading." In his view, such a debate was unhelpful because people do not run their business around regulatory boundaries and should not be required to do so.[39]

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33 Q 24.

34 Q 7.

35 Ibid.

36 Q 42.

37 Q 41.

38 Q 33.

39 Q 7.

23. On the other hand, Thierry Philipponnat argued that the key question was "whether we want markets to be meaningful places where transactions happen or whether we are comfortable with transactions happening in the dark." He welcomed the Commission's intention to bring the OTC market on exchange or on to regulated venues. He asserted that, rather than allowing transactions that are large in size to be dealt with over-the-counter because of their potential market impact as originally intended, 87% of OTC transactions now involve smaller than large-in-size transactions, which "could and should be done on the lit market instead." Although the OTF category would be less regulated than the existing venues it was still in his view preferable to pure OTC. However, he warned of the risk of regulatory arbitrage, with MTFs being degraded to become OTFs. He suggested that a preferable solution would be to give a clear definition of what OTC transactions should comprise.[40]

24. Professor Moloney warned of the danger of trying to shape the market through legislation, and did not wish to see the OTC sector characterised as the "dark side of the market".[41] Professor Avgouleas agreed that, although the presence of systemic risk and investor protection risk should mean that trading in financial instruments is moved on exchange, that did not mean that all OTC instruments should be.[42]

25. The Government also expressed concern about the potential implication of a ban on 'own capital' being used within OTFs to provide liquidity to investors, and warned that any features that necessitate fundamental changes to firms' business models need to be fully evidenced.[43] Given the size of the OTC derivatives market in London, the Government stressed that ESMA's judgment over which asset classes are sufficiently liquid to warrant mandatory trading on organised venues could have significant implications for the future of OTC derivatives trading. As such they are seeking to ensure that fundamental decisions about the future shape of derivatives markets cannot be taken at Level 2.[44]

26. **We acknowledge the Commission's rationale in proposing the introduction of a new category of Organised Trading Facility (OTF) in order to bring trading on to more organised electronic venues. We also acknowledge the evidence that has been put to us that the over-**

40 QQ 18, 24.

41 Q 45.

42 Ibid.

43 EMs 15938/11 and 15939/11, op. cit., paras 55–58.

44 Ibid., paras 67–68.

the-counter (OTC) market has developed in ways that were not initially foreseen. However, we are concerned about the difficulties that would result from a ban on 'own capital', as well as the amount of detail about the operation of OTFs that has been left to be dealt with at Level 2. There is a wider concern that the expansion of organised electronic venues that would result from the new OTF category would lead to an overly complex regulatory framework which does not distinguish clearly between organised venues and OTC. We are concerned that the likely implications of such a reform have not been fully assessed. It is essential to ensure that market participants, regulators and legislators can all with confidence anticipate the impact of the introduction of an OTF category before a change of such magnitude is introduced.

Pre- and post- trade transparency

27. The discussion of OTC derivatives and the OTF category forms part of a wider debate about transparency. Transparency refers to the extent to which regulators and investors are able to observe activity in markets. For investors transparency improves the price formation process[45] and for regulators it enhances the process of supervision. The pre- and post-trade transparency provisions of MiFID II address the issue of transparency for investors and market participants. Articles 3 and 4 of the Regulation set out pre-trade transparency rules for equities, applying to shares, depositary receipts, exchange traded funds, certificates and other similar instruments traded on an MTF or OTF. All regulated venues must make public the current bid and offer prices, and the depth of trading interest at those prices. The procedure for waiving the obligation for pre-trade transparency has been changed, with new powers being given to ESMA on determining the appropriateness of the waiver. Articles 7 and 8 extend pre-trade transparency requirements to non-equities, specifically bonds and structured products admitted to trading on a regulated market, emission allowances, and derivatives admitted to trading or which are traded on an MTF or OTF. The same arrangements also apply for granting waivers.[46] Article 9 extends post-trade transparency requirements to non-equity instruments in a similar manner. Provision is made for competent authorities to authorise deferred publication and for ESMA to have a

[45] It also assists the operation of 'mark to market' valuation of securities in the balance sheets of financial institutions by making public the prices at which securities have recently traded.

[46] EMs 15938/11 and 15939/11, op. cit., paras 11–13.

monitoring role (but not the power of approval that it has in the case of pre-trade transparency waivers).

i) Pre-trade transparency

28. Professor Moloney told us that the sensitivity of pre-trade transparency lay in the fact that, when you tell the market you are about to trade, it is extraordinarily valuable information: "You are putting yourself out there saying, 'I will do this at X price'."[47] She said that some basic pre-trade transparency information, such as indicators of what a trader wants to buy or sell, was justifiable because nobody is seeking to interfere with the orders. However, she argued that MiFID II seemed to have taken the view that everything should be transparent, and to have forgotten the potential costs involved.[48] She expressed the fear that, if MiFID II gave the impression that there should be more and more transparency and that things should be pushed more into the regulated sphere, then things may be made more difficult for pension funds, which need to go under the radar for legitimate reasons.[49]

29. Christian Krohn told us that, whilst AFME supported the transparency agenda, they were concerned that the proposed requirements for pre-trade transparency for non-equity trading venues might not be appropriate for all models of trading. He argued that the proposal to make the same quotes available to other clients and making certain quotes available publicly would have a negative impact on market liquidity and investor choice.[50] Guy Sears had similar concerns, and warned that the Commission was attempting to address non-equity as if it was a single category. He again expressed concern at the scope of delegated powers.[51]

30. Thierry Philipponnat told us that pre-trade transparency for equities was essential for investors to deal at a price that makes sense to them and to show them what the best bids are. However, he acknowledged that bond markets were fundamentally different in nature from equity markets, because some corporate bonds trade only rarely. For derivatives transactions, his view was that, whilst the vast majority should be subject to pre-trade transparency, large transactions may not need to be. He stressed the importance of

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47 Q 40.

48 Q 41.

49 Q 42.

50 Q 1.

51 Q 7.

distinguishing between asset class and type of transaction in applying the principle of transparency.[52]

31. Dr Swinburne agreed, suggesting that pre-trade transparency might prove problematic in the wholesale market. Rather than adopting a one-size-fits-all approach, it was important to differentiate on the basis of liquidity, and thereby avoid a damaging negative effect on the sovereign bond market and corporate market in the current economic climate. In her view, it was possible to differentiate depending on asset class as to whether that pre-trade transparency needs to be applied. She said that the European Parliament was attempting to provide a definition of what ESMA needs to look at in order to come up with a definition of what needs pre-trade disclosure.[53] Professor Avgouleas pointed out that decisions to quote or bid are based on costly research, and if that information is widely disseminated, "everybody can free-ride on the cost that other trades have incurred".[54]

32. The Government stated that the requirement that dealers make their trading interest public poses the risk that, to compensate themselves for the risk of adverse market movements, they will widen their bid-offer spreads or cease to offer markets in certain instruments, leading to a reduction in liquidity and an increase in costs of funding for bond issuers. They concluded that the impact remains uncertain until the Commission sets out in delegated acts the circumstances in which a transparency waiver can be granted. The Government are therefore working to achieve clarity in the Level 1 text about the factors that the Commission will take into account in deciding on which models to provide with a waiver.[55]

ii) Post-trade transparency

33. In terms of post-trade transparency, Mr Philipponnat argued that it was essential in order to provide the market with vital information. He also stressed the need for a consolidated information tape.[56] However, Christian Krohn told us that the proposals for post-trade transparency for non-equities should also bear in mind the liquidity profile of the instruments concerned.[57]

34. Dr Swinburne agreed with Mr Philipponnat that the situation was very different in relation to post-trade transparency, because it gives "a very good

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52 Q 21.

53 QQ 18, 21.

54 Q 40.

55 EMs 15938/11 and 15939/11, op. cit., paras 59–63.

56 Q 21.

57 Q 1.

feel in the bond market for what the pricing mechanisms are and where the prices currently are." She cited the experience of the USA as demonstrating that the effect on liquidity could be beneficial. She would prefer to have information in the market rapidly about a large trade taking place, even if the volume of the order had to be masked. She too stressed that data quality needed to be improved across the board, citing the "shocking" lack of clarity as to the volume of OTC trades that take place, where the data suggest a range of between 13% and 40% of the market. She said that although MiFID I had successfully fragmented the market, it had also fragmented data collection. There was therefore a need for "a legislative nudge in the right direction, given that we have not come anywhere close to having a market solution in the last three years."[58]

35. **We understand the thinking behind the Commission's proposals for transparency, in terms of equivalence of market models and investors' access to relevant information and terms of trade. The proposals relating to post-trade transparency are likely to be beneficial for investors and regulators. However, the pre-trade transparency proposals are flawed. It is important to acknowledge the markedly different characteristics of each sector of the market, in particular in terms of their liquidity. A one-size-fits-all approach to pre-trade transparency must therefore be avoided, and the Commission needs to be mindful of the potential of a negative impact on the sovereign bond markets and the corporate bond markets in the current economic climate. In particular, it is not clear that the price formation process will be enhanced by more onerous pre-trade transparency requirements in those markets. As negotiations continue, we urge the Government to ensure that a more flexible approach is adopted, to ensure that the right balance is struck between reaping the benefits of increased transparency and ensuring that the market is able to operate in an effective and efficient manner. Moreover, since the requirements to report transactions to regulators are extended by the recast regulation, the national authorities (such as the FSA and its successors) will be better placed to monitor and supervise market integrity, thereby enhancing market confidence and lowering the cost of capital.**

36. **We acknowledge the evidence we have heard that the fragmentation of the market achieved under MiFID I has also led to a fragmentation in**

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[58] Q 21.

data collection, and therefore to a deterioration in data quality. We support the case for the creation of a timely consolidated information tape and urge the Commission to take urgent steps to bring this about.

Systematic Internalisers (SIs)

37. The transparency principle has also been applied to Systematic Internalisers (SIs). SIs are investment firms which, on an organised, frequent and systematic basis, deal on own account by executing client orders outside regulated markets, MTFs or the new category of OTFs. Articles 17 and 18 of the Regulation extend the obligation to publish firm quotes for those non-equity products to which pre-trade transparency requirements have been applied. The quote must also be made available to other clients of the investment firm in an objective and non-discriminatory way. Firms must undertake to enter into a transaction with the clients to which these quotes are made available if the quoted size is below a size specific to the instrument (to be determined through delegated acts). However, the firm will be able to establish non-discretionary limits to the number of transactions they enter into pursuant to this undertaking. Further quotes at or below the instrument specific size will have to be made public to market participants and investors other than clients of the investment firm.[59]

38. Guy Sears explained that the Systematic Internaliser "is how debt markets operate ... by trading against the risk on the balance sheet of the banks." He feared the impact of the attempt to impose pre-trade transparency requirements on SIs could be serious.[60] Christian Krohn agreed that there were "all sorts of problems" with these proposals. He argued that the requirement to make quotes firm would discourage SIs, and would discourage investment firms from making markets to provide liquidity because they would not be able to revise or withdraw their quotes in the light of rapidly changing market circumstances. He further argued that the proposal to make quotes of a certain size available to other clients ignored the fact that clients have different risk profiles. In his view, public disclosure of a trade would have a negative market impact, because the market would be able to infer the position of the client in question and trade against them.[61]

39. Professor Moloney defined SIs as "those investment firms that, when someone puts in an order to trade a share, instead of sending it to the

59 EMs 15938/11 and 15939/11, op. cit., paras 14–16.

60 Q 8.

61 Ibid.

London Stock Exchange would simply trade against the stock of shares that they had." She observed that SIs had been the major flash-point at the time MiFID I was being negotiated, resulting in a "hugely complex" regulatory architecture. Yet she told us that there were only 12 SIs accounting for 2% of European equity trading, and the way the legislation had been cast meant that it was possible for the industry to manoeuvre around it.[62]

40. Professor Avgouleas agreed that the definition of SIs in MiFID I was not very successful, and stressed that the more layers of rules were created, the more opportunities there were for regulatory arbitrage. He suggested that the SI and OTF regimes could be merged, subject to a strong set of best execution rules.[63] Dr Swinburne agreed that its small size meant that "it is hard to assess the SI regime for equities as anything other than a failure. Clearly the regime is not optimal for trading".[64]

41. The Government stated that the requirement to make quotes available to other clients poses similar issues to those in relation to pre-trade transparency, in that it could result in a reduction of liquidity. The Government are therefore requesting further guidance from the Commission as to the purpose of the regime, what sort of trading it envisages will be captured, and what impact on liquidity is foreseen.[65]

42. **Whilst we recognise the Commission's desire to provide greater transparency and equivalence between market models in the operation of Systematic Internalisers, we conclude that the regulatory regime set out in MiFID I has been unsuccessful, as demonstrated by the unwillingness of market participants to adopt the SI model. It would be undesirable for the reach of such a flawed regime to be extended further, as MiFID II proposes.**

b) Algorithmic and high-frequency trading (HFT)

43. Article 17 of the draft Directive requires firms that engage in algorithmic trading to have effective systems and risk controls in place, including continuity plans. Algorithmic trading strategies will also be required to be in continuous operation during trading hours of venues being used, and to post firm quotes at competitive prices in order to provide liquidity on a regular

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62 QQ 35–36.

63 Q 37.

64 Dr Kay Swinburne MEP, Supplementary Written Evidence.

65 EMs 15938/11 and 15939/11, op. cit., paras 64–66.

and ongoing basis. These proposals would apply equally to the use of algorithmic trading in the context of high-frequency trading (HFT).[66]

44. Chris Bates thought that the Commission's definition was unhelpfully broad, because it would mean that "anybody who uses computers to assist their trading—pretty much everybody—will have an obligation to make firm quotes."[67] Dr Swinburne agreed that, as currently drafted, the proposal would mean that all buy-side firms that use an execution-only algorithm to put on their order would have to become market-makers and make two-way prices. However, in her view that was an unintended error that would be corrected through the legislative process.[68]

45. Although Professor Avgouleas asserted that lots of the requirements in MiFID II were reasonable, he pointed out the distinction between algorithmic trading (which he argued makes the market more efficient) and HFT (which he said is like "a financial arms race"). He feared that the proposals did not demonstrate an understanding of what HFT actually was. He argued that, unless the "rather controversial" view was accepted that too much innovation in the marketplace was undesirable and needed to be prevented, regulation would be struggling to keep up with technological developments as soon as MiFID II was implemented. In his view, countering any problems associated with high-frequency trading was much more a question of technology than of regulation. He argued that the biggest problem with HFT was that it slices orders into smaller units, creating problems for pension funds and other institutional investors who need to conclude a very large trade.[69]

46. Professor Moloney also stressed the difference between the two, telling us that algorithmic trading was simply about computer programs trading, whereas high-frequency trading was extraordinarily speedy, high-volume trading. She considered that it was very unclear whether high-frequency trading is a good or a bad thing, since "you can pile up studies on either side that say either that high-frequency trading brings liquidity, produces better trading and provides better price formation or, on the other side, that it causes a lot of difficulties." In her view, legislation had to be careful not to

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66 Ibid., para 19. Algorithmic trading can be defined as a form of trading in which the decision to trade, its timing or terms (e.g. as to price) are determined by conditions specified in a mathematical formula. The objective is to enable market participants and investors to respond quickly (normally in an automated manner) to new information or market trends which are relevant for the price of financial instruments. It is a technique that is often used in high-frequency trading (HFT). See Glossary.

67 Q 9.

68 Q 18.

69 QQ 42–44.

create difficulties for something that could be useful in certain circumstances. Yet her conclusion was that the MiFID II proposals were broadly reasonable.[70]

47. Thierry Philipponnat thought that the proposal addressed the issue of high-frequency trading "in a very clear manner", although he too observed that the proposal did not effectively distinguish between algorithmic trading and high-frequency trading (which in his view should be regarded as a subset of algorithmic trading).[71] He told us that there was confusion between volume and liquidity: "When the HFT professionals say that we need speed to make markets, they mean that they need to be fast enough not to stick to a price when the customers want to trade. ... this is exactly the opposite of what liquidity provision is about. ... That technique is called smoking in the market and is the way it works all the time." Mr Philipponnat said that the speed with which HFT traders can input and withdraw instructions to trade can work against other investors who lack the technology to access the market in the same way. He argued that the other main strategy in HFT was "trend following or front-running", which involved detecting trading patterns used by large institutional investors, getting in front of the trader and seeking to benefit. In his view, such activity was of no benefit to investors.[72]

48. Dr Swinburne supported the proposals to regulate the activity of such operators who only post orders either on the bid or on the offer[73] throughout the day, and were flat at the end of the day (thereby effectively acting as a market maker). She pointed out that such operators make up 40% of the volume of European traders. Likewise, steps to strengthen the venues themselves, such as circuit-breakers and tighter controls on market access, were appropriate measures to put in place. On the other hand, she did not think that such market operators should be forced to stand in the way of a falling market, although they could be forced to stay within certain predefined risk parameters.[74]

49. Christian Krohn said that AFME were supportive of the requirement for all participants with direct access to a venue to be authorised, supervised and subject to appropriate pre-trade risk controls, as well as the proposal for circuit-breakers. However, he described the requirement for algorithmic trading strategies to be in operation throughout the trading day as "extremely

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70 Q 43.

71 QQ 18, 23.

72 Q 28.

73 i.e. to buy (only) and to sell (only), respectively.

74 Q 28.

problematic", because of the need for a safety valve in times of market stress and in circumstances when the algorithm might "misfire". His counterproposal was for the operator of an algorithm deemed to be a beneficiary of the venue to which it sends its orders to be obliged to make markets in certain circumstances.[75]

50. Professor Moloney was also critical of these provisions. She did not think the proposal to trade continuously made sense because it was normal and reasonable for traders such as long-term buy-side investors who use algorithmic programs to trade only in the morning, at the close of the day and when there is a major market announcement. She described the requirement to operate on both sides of the market as "an overkill reaction".[76]

51. The Government welcomed many of the Commission's proposals in this area, particularly those which provided greater clarity of the organisational requirements and risk controls which apply to users of algorithms. However they too expressed concern about the requirement for an algorithmic trading strategy to be in continuous operation and to post firm quotes at competitive prices. They agreed that as drafted the requirement would capture a very wide range of trading strategies, including those used by traditional investors and asset managers to minimise the market impact of their trading, and would have a detrimental effect on market liquidity. The Government stated that they are seeking to work with the Commission to clarify the purpose and scope of the measure.[77]

52. **High-frequency trading remains a deeply controversial activity, and there is a wide spectrum of views and evidence as to its utility. Further research is needed in order to determine with any certainty the impact of high-frequency trading on financial markets and on the economy as a whole. To this end we look forward to the publication of the final report of the Government's Foresight project on the Future of Computer Trading in Financial Markets. In the context of such uncertainty, whilst there appears to be a strong case for such devices as circuit breakers, we are concerned that some elements of the Commission's proposals may prove counterproductive. We are concerned that the scope of the Commission's proposals is too broad, and that the distinction between algorithmic trading and high-**

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75 Q 9.

76 Q 43.

77 EMs 15938/11 and 15939/11, op. cit., paras 69–70.

frequency trading needs to be more carefully drawn. In particular, the proposal to require algorithmic trading strategies to be in operation throughout the trading day is likely to have a detrimental effect on financial markets. We urge that careful attention be given to the proposals and their likely implications in this complex and controversial field.

c) Third country access

53. Article 41 of the recast Directive seeks to introduce new rules regarding the establishment of branches by third country firms, and Article 36 of the Regulation seeks to introduce new requirements for the provision of services without a branch by third country firms. A branch in the EU will be required in order to provide investment services or activities to clients other than eligible counterparties (the "eligible counterparty exemption"). Since many institutional investors are classified at their own initiative as professional clients so as to be protected by MiFID's conduct of business rules, they would not fall within the eligible counterparty exemption. Branches cannot be authorised until the Commission has made a determination about whether the home jurisdiction of the third country firm provides equivalence to the requirements set out in MiFID and the Capital Adequacy Directive. The third country must provide for equivalent reciprocal recognition of the prudential framework under MiFID. Third country firms providing cross-border services without a branch will be required to register with ESMA. Before ESMA can register a third country firm, the home jurisdiction of that firm must have been deemed equivalent and reciprocal by the Commission. Firms authorised under the branch provisions will be able to passport their services within the EU. Transitional provisions for existing firms will last for four years from the entry into force of the Directive and the Regulation.[78]

54. This proposal is one of the most contentious elements of the MiFID II package. Chris Bates told us that MiFID I had left the question of third-country firms alone, resulting in a "patchwork of different approaches" based on Member State discretion. Although there was broad acceptance that there should be some form of European harmonisation, he said that the Commission's proposals were unhelpful because they depend on assessments of equivalence and reciprocity, which few countries were likely to pass: "Effectively, we would be saying to the rest of the world, 'Don't call us; we'll call you'." He said that it would have a potentially devastating impact on London as a financial centre, which has about 20 branches of often

78 Ibid., paras 20–23.

significant foreign banks from a diverse range of countries, and because London firms do business in dozens of other countries.[79]

55. Guy Sears and Christian Krohn agreed with this analysis.[80] Mr Krohn advocated a much more pragmatic approach to the application of equivalence, based not on line-by-line comparison of rules and regulations between Member States and third-country jurisdictions, but rather on regulatory objectives. He said it was unrealistic to expect over 100 equivalence assessments to be completed within a four year timeframe.[81] Mr Bates also advocated a more flexible model, along the lines of that operating in the UK.[82]

56. Dr Swinburne agreed that the third-country provisions were weak and contradictory. She pointed out inconsistency with the provisions in EMIR. Language about reciprocity had been taken out of EMIR because of the high hurdle it presented, and because it was likely to be in contravention of World Trade Organization (WTO) agreements. In her view, strict equivalence and reciprocity would effectively close down the EU financial markets. She cited amendments that had been tabled in the European Parliament to introduce a transitional regime so that existing regimes between Member States and other areas could continue in place for as long as necessary or until a year after the Commission had made an equivalence decision, or for the Commission to begin its assessment with the most important jurisdictions, such as the US and the big Asian markets.[83]

57. Professor Avgouleas told us that the proposal would limit the access of third-country firms to "fortress Europe". He conceded, however, that third country firm access to the retail investment market needed to be regulated in order to protect investors, "but that is a different thing from shutting down the borders of European markets to third-country providers and especially wholesale service providers."[84]

58. Professor Moloney argued that those wishing to have access to European consumer markets should have a branch. In the wake of the financial crisis, she also sympathised with the desire of regulators to "know who is there and what they are dealing with". She stressed that a driver of the reforms was the desire to register market participants rather than to regulate them, as well as

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79 QQ 1, 11.

80 Ibid.

81 Q 11.

82 Ibid.

83 QQ 18, 29.

84 Q 47.

to seek to put in place internationally certain baseline standards on how the wholesale markets behave. However, she found it difficult to see how ESMA's proposed power to deregister third-country firms if they were not compliant would work in practice.[85]

59. The Government argued that the proposals represented a considerable tightening of the current access requirements, and that it was unlikely that many third country jurisdictions would meet the equivalence and reciprocity tests. They argued that erecting such barriers could have a significant negative effect on the ability of European investors to spread and hedge investment risk and of European businesses to access key global funding sources. They stated that transitional provisions should be strengthened to avoid denying access to third country firms before an equivalence determination had been made.[86]

60. **Whilst we recognise the legitimate desire to introduce greater harmonisation across the EU in relation to third country access, the Commission's proposals are deeply flawed. There is a risk that, if introduced, such provisions could lock third country firms out of the EU markets, which, taking into account the risk of regulatory retaliation, would have an extremely damaging effect on European financial markets, and in particular the City of London. Given that global financial markets are independent of geography, we believe this to be wholly impractical. We are pleased that amendments have been proposed in the European Parliament to correct the weaknesses of the Commission's proposal. Given the vital strategic importance of the UK financial sector, not only for the domestic economy but also for the EU as a whole, and also given its international character, we urge the Government to work to ensure that any provision on third country access will not have a detrimental effect on the UK financial market or on the EU financial sector as a whole. We support the Government's view that lengthy transitional periods for existing firms would be essential.**

d) Regulation of commodities markets

61. Article 59 of the recast Directive introduces rules to support liquidity, prevent market abuse and to provide for orderly functioning of commodity derivatives markets. It gives the Commission the power to specify, via delegated acts, position limits (or alternative arrangements with equivalent

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85 Ibid.

86 EMs 15938/11 and 15939/11, op. cit., paras 71–73.

effect) on the number of commodity contracts which any person can hold. National competent authorities are required to ensure that such limits are in place. Article 35 of the Regulation gives ESMA a power to intervene actively in positions to preserve market integrity and orderliness where there is a threat to financial stability or to the functioning of commodities financial markets, where a national competent authority has not taken sufficient measures to address the threat.[87]

62. Christian Krohn told us that he understood the Commission's objectives of seeking to ensure that regulators had necessary powers to monitor the position of entities in those markets and to take appropriate action where necessary. However, he argued that the proposal was flawed. Far from being a panacea, he regarded position limits as "a very clumsy instrument that risks having a materially negative impact on liquidity, investor choice and price formation in those markets." Instead, he advocated a spectrum of measures that regulators could require market operators to impose on participants in the commodity derivatives market.[88]

63. On the other hand, Thierry Philipponnat argued that the treatment of agricultural and commodity derivatives was one of the strengths of the MiFID II package.[89] He told us that commodity derivatives markets served a useful purpose of hedging for market participants, such as institutions or people who have a normal economic interest in producing, selling and buying commodities. Yet what he described as the "financialisation" of commodity markets was a perverse phenomenon, because none of the money placed by investors in commodity markets went to productive use, but instead remained in the financial system: "This is not investing but betting." He told us that research showed that between 20% and 30% of speculation on agricultural commodity markets was necessary for price formation, with the remaining 70% creating a distortion in the market. He added that there are about $500 billion of financial products linked to commodity markets, with a consequential detrimental effect on the actual level of food prices.[90]

64. Dr Swinburne supported the proposals because they were in line with the G20 commitment on commodities and the findings of the International Organization of Securities Commissions (IOSCO) task force on Commodities Futures Markets.[91] In her view, commodity markets were

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87 Ibid., paras 24–26.

88 Q 13.

89 Q 18.

90 Q 31.

91 Q 18. See https://www.iosco.org/library/pubdocs/pdf/IOSCOPD285.pdf.

global and should be regulated as such, and she therefore welcomed the fact that the IOSCO task force's findings had effectively been transposed into MiFID II.[92] Professor Avgouleas agreed that coordinated disclosure and position limits could prove helpful in deterring or detecting market manipulation. However, he stressed that the proposals would not eliminate food price volatility, which is, above all, driven by supply and demand.[93]

65. The Government stated that they support the goal of ensuring commodity derivatives markets operate in a transparent, fair and orderly way, and welcomed the overall objectives of the proposed regime to support liquidity, prevent market abuse and support orderly pricing. In the Government's view, the most effective way to achieve this is to deploy a wide and flexible position management approach, based on strong supervision and market monitoring, allowing regulators and exchanges to intervene, including making traders wind down positions of any size where they are deemed of concern to the exchange or market authority. The Government therefore argued that it is important that the alternative arrangements to position limits, as proposed in Article 59, are allowed to function fully, as a primarily limits-based approach would not necessarily produce a more robust regulatory regime, and could potentially harm liquidity and market functioning if set at the wrong level. The Government also expressed reservations about the power granted to the Commission to establish the rules, via delegated acts, regarding position limits and alternative arrangements. They argued that decisions on when and at what level to apply limits or other arrangements most appropriately rest with the authority conducting the front-line supervision of those markets.[94]

66. We observe that amendments have been put forward in the European Parliament to impose position limits on all trading venues which trade commodity derivatives. We are also currently scrutinising the proposals for a Regulation and a Directive on insider dealing and market manipulation (market abuse), which deals with a number of related issues in relation to market abuse and manipulation, and are engaged in correspondence with the Government on the proposals.[95]

67. **There is a divergence of views on the proposals for regulation of commodities markets. In our view, whilst the Commission's proposals could be a useful deterrent to market manipulation, there is also potential for a serious negative impact on liquidity, investor**

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92 Q 31.

93 Q 50.

94 EMs 15938/11 and 15939/11, op. cit., paras 75–79.

95 See EMs 16000/11 and 16010/11, and Correspondence with Ministers, op. cit.

choice and price formation. Furthermore, the Commission's proposals will not eliminate the price volatility of markets such as those dealing in food commodities. Such volatility is dependent upon a range of factors, and is in particular driven by supply and demand. Beneficial as increased regulation may be, it can only provide a partial solution.

e) Investor protection and corporate governance

Investor protection

68. Article 24 of the draft Directive introduces a requirement for investment advisers to make it clear on what basis they provide advice, specifying whether it is on an independent basis and whether it is based on a broad or restricted analysis of the market. Restrictions are placed on commission payments to firms providing investment advice. The recast Directive also introduces requirements on firms that execute orders for clients to publish data on the quality of their execution and on the execution venues used to execute client orders, in sufficient detail that clients can understand how their orders will be executed.[96]

69. Christian Krohn argued that the MiFID I regime had worked well in providing investor protection, and questioned the need for further reforms. He expressed concern that, in its eagerness to extend maximum protection to retail investors, the Commission risked imposing undue burdens on wholesale market participants.[97] Guy Sears argued that the Commission's proposal to place a ban on inducements on independent advisers only was unacceptable from a consumer perspective. He told us that, "given that there is no definition of independent, if there is a huge cost to being independent, people will just do whatever is necessary to describe themselves as not independent. This is just a very clumsy, cliff-edge rule." He suggested a provision closer to the FSA's Retail Distribution Rule (RDR) position, with no commissions payable direct to any advisers (either independent or non-independent) for any products, thus ensuring a level playing field.[98]

70. Professor Moloney also thought MiFID II was a "missed opportunity" because it had only addressed the role of independent advisers.[99] Dr Swinburne agreed, and argued in favour of a "hard disclosure regime" so

96 EMs 15938/11 and 15939/11, op. cit., paras 29–32

97 Q 4.

98 Q 5, and Guy Sears, Supplementary written evidence.

99 Q 50.

that all advisers, whether independent, dependent or tied, were subject to the same disclosure of every level of fee that is made. She suggested that MiFID II should adopt the principle of the UK RDR by requiring Member States to impose a minimum qualification level for those who give financial advice.[100] Thierry Philipponnat was of the view that transparency was not sufficient, but that inducements should be banned outright, because they were a way of hiding the margin received as a result of sales.[101]

71. The Government welcomed the Commission's efforts to increase the overall level of protection for investors, but stressed that there must be an appropriate balance between protection, accessibility, consumer responsibility and cost.[102] We also acknowledge that amendments have been put forward in the European Parliament to replace the ban on commission with a series of explicit upfront disclosures.

72. **Whilst the Commission is right to seek to strengthen investor protection by building on the important steps taken under MiFID I, we conclude that its proposals as currently drafted are flawed. Restricting the ban on inducements to independent advisers will be unworkable, since advisers will simply take steps to avoid being classified as independent. A more consistent approach to consumer advice is needed to ensure that consumers are adequately protected. One model for this is the approach adopted by the FSA in its Retail Distribution Review, which deals with the status and remuneration of advisers generally, and prohibits all payments in the form of commission.[103] In our view, this would be preferable.**

Corporate governance

73. Article 9 of the Directive introduces provisions for investment firms concerning the governance arrangements of their management bodies. Equivalent provisions for market operators are introduced in Article 48 of the Directive. These include restrictions on the holding of multiple directorships. Firms and operators must also take into account diversity as one of the criteria for selecting members of the management body. ESMA will be tasked with developing draft regulatory technical standards concerning the make-up of the management body, and in benchmarking diversity.[104]

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100 Q 32 and Dr Kay Swinburne, Supplementary written evidence, op. cit.

101 Q 32.

102 EMs 15938/11 and 15939/11, op. cit., paras 80–82.

103 Or "inducements" in the terminology used in MiFID II.

104 EMs 15938/11 and 15939/11, op. cit., paras 34–36.

74. Guy Sears acknowledged the need to ensure that firms were well governed, but questioned the proportionality of some of the proposals. For instance, he argued that the requirements for nomination committees, diversity and openness would be extremely difficult for a small firm to comply with. He also argued that the requirement to have non-executive directors was out of step with the business model of many firms.[105] Both he and Chris Bates expressed concern that this was a prescriptive regulatory model without sufficient flexibility to take account of such factors.[106] Christian Krohn agreed that many of the proposals were excessive, and did not appreciate the difference in role between executive and non-executive directors.[107] Professor Moloney was sceptical as to whether the corporate governance proposals would necessarily lead to stronger investor protection outcomes.[108]

75. There is no reference to the role of auditors in the MiFID II proposals on corporate governance. The role of auditors in the financial crisis has not attracted much attention, despite their central role in seeking to ensure the accountability of boards of directors to shareholders and in the evaluation of risk in the financial sector.[109]

76. **We acknowledge the need to ensure adherence to good standards of corporate governance, but the Commission's proposed approach is overly prescriptive. We do not believe that the MiFID II package is the appropriate mechanism by which to seek to achieve the Commission's goals. If these provisions are retained, then it is essential that greater flexibility is provided so as to take account of the diverse size, capacity and business models of the range of market participants.**

f) The role of ESMA and the power to intervene

The role of ESMA

77. This report has explained that MiFID II proposes to grant ESMA a range of new powers and responsibilities. As we have seen, Dr Swinburne expressed concern about the balance between Level 1 and Level 2.[110] She told us that

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105 Q 5.

106 Q 6.

107 Ibid.

108 Q 49.

109 See the Auditing Practices Board Guidance to Auditors in Assessing Companies Corporate Governance and Going Concern Statements at http://www.frc.org.uk/apb/press/pub2191.html. See also House of Lords Economic Affairs Committee, 2nd report (2010–12), *Auditors: Market concentration and their role* (HL Paper 119)

110 See above, para 13.

ESMA's role in rule-making and technical standards was in its infancy, but that the legislative proposals in which it had thus far been given a role, such as the Alternative Investment Fund Managers Directive (AIFMD),[111] and in relation to hedge fund management and short selling, were "very politically motivated dossiers" with "lots of grey areas left in Level 1. That means that, in Level 2, when it comes to writing those technical standards, it has proved quite problematic as to what is a political decision versus what is just implementation." She told us that EMIR made the role of ESMA much clearer, and stressed the need in MiFID II to specify in Level 1 significant parameters to its work.[112] She added that ESMA's value lay in creating a common rulebook for financial services regulation as a whole. But she stressed that ESMA cannot make political decisions nor have any discretion—its role should be restricted and tightly controlled.[113]

78. Guy Sears told us that ESMA should have a coordinating role. In terms of the balance of responsibilities between ESMA and national regulators such as the FSA and its successors, he argued in favour of consideration on a case-by-case basis. However, there was a resource issue, in that ESMA had been given so many roles that the national authorities were required to resource it, thus retaining a measure of control.[114]

79. Christian Krohn was also concerned about the resources available to ESMA. He advocated a more pragmatic approach in order to allow ESMA to deliver quality regulation and advice, and in a timeframe allowing for meaningful consultation with the industry.[115] Professor Avgouleas also predicted that ESMA would be overstretched and would rely on national regulators. He feared the creation of "layers upon layers of European regulation", making the regulatory process more expensive, especially for smaller firms.[116] On the other hand, Thierry Philipponnat stressed that "if we believe we want a single market, we need a regulator that will coordinate everything."[117]

80. Professor Moloney told us that various factors had to be borne in mind. First, in her view, when a decision was being made that had fiscal consequences for local taxpayers, it should not be done at centralised European level. Second, though ESMA's rule-making capacity made sense, it

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111 See House of Lords European Union Committee, 3rd report (2009–10), *Directive on Alternative Investment Fund Managers* (HL Paper 48).

112 Q 19.

113 Q 30.

114 Q 12.

115 Ibid.

116 Q 48.

117 Q 30.

was more efficient for direct supervision to take place at local level. But in her view, the powers that are proposed for ESMA were "fairly carefully calibrated" and "within the spirit of the original regulation" when ESMA was set up.[118]

ESMA and product intervention powers

81. One significant power being granted to ESMA relates to product intervention. Article 32 of the Regulation gives a competent authority the power to prohibit or restrict in that Member State the marketing, distribution or sale of certain financial instruments or types of financial activity, if there are significant investor protection concerns, or a serious threat to the orderly functioning and integrity of financial markets or the stability of the financial system. Article 31 of the Regulation gives ESMA powers to prohibit temporarily or restrict such activity in the EU on the same basis, and where competent authorities have not taken action to address the threat.[119]

82. Chris Bates thought that the product intervention powers were significant because they grant a very broad regulatory, almost legislative, power to national regulators and ESMA. The potential impact of this was in his view largely unexplored.[120] More broadly, the expansion of ESMA's direct supervision powers was an issue of concern, since some of the issues over a lack of discretion would become more significant if a broader range of entities were supervised at the EU level. He predicted that this could become a more significant question in the next round of regulation.[121]

83. Professor Avgouleas questioned whether you could ban an investment service or financial product given the accountability structures under which ESMA operates, since "there is a massive difference between scrutinising an instrument or service and prohibiting one."[122] On the other hand, Professor Moloney thought that the proposed product intervention powers were "innovative and experimental, and potentially very useful because ESMA is developing a consumer protection theme to its work". She also thought that it may be easier for a European regulator to act than a local regulator.[123]

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118 Q 48.

119 EMs 15938/11 and 15939/11, op. cit., para 33.

120 Q 1.

121 Q 12.

122 Q 48.

123 Ibid.

84. This Committee has taken a consistent interest in the workings of ESMA and the other European Supervisory Authorities (ESAs), most recently through the publication of our July 2011 report on the EU Financial Supervisory Framework.[124] In that report we stressed that day-to-day supervision of financial institutions should remain at a national level. In terms of temporary bans, we concluded that though national supervisory authorities should intervene in exceptional circumstances to impose restrictions necessary to ensure financial stability, such actions should take place in a uniform and coordinated way across the EU. We welcomed the ESAs' coordinating role, but considered that they should only have the power to ban temporarily certain activities or products in a crisis, when an emergency has been declared by the Council.

85. **We conclude that ESMA has a vital role to play in coordinating regulation of financial markets across the EU. However, whilst its rule-making powers are broadly accepted, there is less consensus about the degree to which ESMA should engage in direct regulation of the financial markets, as suggested in the Commission's proposals for ESMA to take on product intervention powers. There are also significant resource issues for such a small organisation, and there is a strong likelihood that ESMA will need to rely on leading national regulators, including the FSA and its successors, to fulfil its tasks. We reiterate our view that day-to-day supervision of financial institutions should remain at a national level, and that an EU regulator should only have the power to intervene in exceptional circumstances.**

[124] See House of Lords European Union Committee, 20th Report (2010–12), *The EU Financial Supervisory Framework: an update* (HL Paper 181).

CHAPTER 4: SUMMARY OF CONCLUSIONS

Chapter 1: Introduction

86. We agree with our witnesses that a review of MiFID I was necessary, not least because of the technological advances that have taken place since it came into force. Nevertheless, we are deeply concerned at the speed with which MiFID II has been brought forward. With a package of the size, complexity and importance of MiFID II, it is more important to get the legislation right than to get it passed quickly. The consequences of poorly drafted legislation could be damaging for the EU financial sector, and for the economy as a whole. We urge the UK Government, the Commission, Council and European Parliament to take all steps necessary to ensure that the legislation is fit for purpose before it comes into force. Given the important co-decision powers that the European Parliament now possesses, we particularly urge the Government to ensure that they liaise with and pay due attention to the European Parliament in its consideration of the MiFID II proposals. (para 9)

Chapter 2: MiFID: An overview

87. The view has been expressed to us that the Commission's proposals are a "good starting point" for negotiations. Yet, as we explore in detail in Chapter 3, significant improvements in the text are required before it is implemented, and we welcome the steps taken thus far in the European Parliament and in the Council to address these issues. Broadly speaking, the Commission needs to ensure that MiFID II is consistent with other legislative packages, in particular EMIR. It is also important to ensure that as much clarity as possible is set out in the detail of the Level 1 framework text. (para 15)

88. We further note that there is a tension between a rules-based and a principles-based approach in terms of how to structure the regulatory system in order to anticipate market developments, in seeking to balance flexibility with accountability in the exercise of delegated powers, and in providing sufficient legal certainty to satisfy market participants. In our view, MiFID II does not resolve that tension. Furthermore, there needs to be a recognition that MiFID II, however well it is drafted, will not be the final word in financial market regulation. The single market in financial services is constantly evolving, and it is impossible to predict with any certainty how it will do so in the future. We therefore conclude that further packages of legislative reforms are inevitable. (para 16)

Chapter 3: Assessing MiFID II in detail

Organised Trading Facilities (OTFs) and the over-the-counter (OTC) market

89. We acknowledge the Commission's rationale in proposing the introduction of a new category of Organised Trading Facility (OTF) in order to bring trading on to more organised electronic venues. We also acknowledge the evidence that has been put to us that the over-the-counter (OTC) market has developed in ways that were not initially foreseen. However, we are concerned about the difficulties that would result from a ban on 'own capital', as well as the amount of detail about the operation of OTFs that has been left to be dealt with at Level 2. There is a wider concern that the expansion of organised electronic venues that would result from the new OTF category would lead to an overly complex regulatory framework which does not distinguish clearly between organised venues and OTC. We are concerned that the likely implications of such a reform have not been fully assessed. It is essential to ensure that market participants, regulators and legislators can all with confidence anticipate the impact of the introduction of an OTF category before a change of such magnitude is introduced. (para 26)

Pre- and post-trade transparency

90. We understand the thinking behind the Commission's proposals for transparency, in terms of equivalence of market models and investors' access to relevant information and terms of trade. The proposals relating to post-trade transparency are likely to be beneficial for investors and regulators. However, the pre-trade transparency proposals are flawed. It is important to acknowledge the markedly different characteristics of each sector of the market, in particular in terms of their liquidity. A one-size-fits-all approach to pre-trade transparency must therefore be avoided, and the Commission needs to be mindful of the potential of a negative impact on the sovereign bond markets and the corporate bond markets in the current economic climate. In particular, it is not clear that the price formation process will be enhanced by more onerous pre-trade transparency requirements in those markets. As negotiations continue, we urge the Government to ensure that a more flexible approach is adopted, to ensure that the right balance is struck between reaping the benefits of increased transparency and ensuring that the market is able to operate in an effective and efficient manner. Moreover, since the requirements to report transactions to regulators are extended by the recast regulation, the national authorities (such as the FSA and its successors) will be better placed to monitor and supervise market integrity,

thereby enhancing market confidence and lowering the cost of capital. (para 35)

91. We acknowledge the evidence we have heard that the fragmentation of the market achieved under MiFID I has also led to a fragmentation in data collection, and therefore to a deterioration in data quality. We support the case for the creation of a timely consolidated information tape and urge the Commission to take urgent steps to bring this about. (para 36)

Systematic Internalisers (SIs)

92. Whilst we recognise the Commission's desire to provide greater transparency and equivalence between market models in the operation of Systematic Internalisers, we conclude that the regulatory regime set out in MiFID I has been unsuccessful, as demonstrated by the unwillingness of market participants to adopt the SI model. It would be undesirable for the reach of such a flawed regime to be extended further, as MiFID II proposes. (para 42)

Algorithmic and high-frequency trading (HFT)

93. High-frequency trading remains a deeply controversial activity, and there is a wide spectrum of views and evidence as to its utility. Further research is needed in order to determine with any certainty the impact of high-frequency trading on financial markets and on the economy as a whole. To this end we look forward to the publication of the final report of the Government's Foresight project on the Future of Computer Trading in Financial Markets. In the context of such uncertainty, whilst there appears to be a strong case for such devices as circuit breakers, we are concerned that some elements of the Commission's proposals may prove counterproductive. We are concerned that the scope of the Commission's proposals is too broad, and that the distinction between algorithmic trading and high-frequency trading needs to be more carefully drawn. In particular, the proposal to require algorithmic trading strategies to be in operation throughout the trading day is likely to have a detrimental effect on financial markets. We urge that careful attention be given to the proposals and their likely implications in this complex and controversial field. (para 52)

Third country access

94. Whilst we recognise the legitimate desire to introduce greater harmonisation across the EU in relation to third country access, the Commission's proposals are deeply flawed. There is a risk that, if introduced, such

provisions could lock third country firms out of the EU markets, which, taking into account the risk of regulatory retaliation, would have an extremely damaging effect on European financial markets, and in particular the City of London. Given that global financial markets are independent of geography, we believe this to be wholly impractical. We are pleased that amendments have been proposed in the European Parliament to correct the weaknesses of the Commission's proposal. Given the vital strategic importance of the UK financial sector, not only for the domestic economy but also for the EU as a whole, and also given its international character, we urge the Government to work to ensure that any provision on third country access will not have a detrimental effect on the UK financial market or on the EU financial sector as a whole. We support the Government's view that lengthy transitional periods for existing firms would be essential. (para 60)

Regulation of commodities markets

95. There is a divergence of views on the proposals for regulation of commodities markets. In our view, whilst the Commission's proposals could be a useful deterrent to market manipulation, there is also potential for a serious negative impact on liquidity, investor choice and price formation. Furthermore, the Commission's proposals will not eliminate the price volatility of markets such as those dealing in food commodities. Such volatility is dependent upon a range of factors, and is in particular driven by supply and demand. Beneficial as increased regulation may be, it can only provide a partial solution. (para 67)

Investor protection and corporate governance

96. Whilst the Commission is right to seek to strengthen investor protection by building on the important steps taken under MiFID I, we conclude that its proposals as currently drafted are flawed. Restricting the ban on inducements to independent advisers will be unworkable, since advisers will simply take steps to avoid being classified as independent. A more consistent approach to consumer advice is needed to ensure that consumers are adequately protected. One model for this is the approach adopted by the FSA in its Retail Distribution Review, which deals with the status and remuneration of advisers generally, and prohibits all payments in the form of commission.[125] In our view, this would be preferable. (para 72)

[125] Or "inducements" in the terminology used in MiFID II.

97. We acknowledge the need to ensure adherence to good standards of corporate governance, but the Commission's proposed approach is overly prescriptive. We do not believe that the MiFID II package is the appropriate mechanism by which to seek to achieve the Commission's goals. If these provisions are retained, then it is essential that greater flexibility is provided so as to take account of the diverse size, capacity and business models of the range of market participants. (para 76)

The role of ESMA and the power to intervene

98. We conclude that ESMA has a vital role to play in coordinating regulation of financial markets across the EU. However, whilst its rule-making powers are broadly accepted, there is less consensus about the degree to which ESMA should engage in direct regulation of the financial markets, as suggested in the Commission's proposals for ESMA to take on product intervention powers. There are also significant resource issues for such a small organisation, and there is a strong likelihood that ESMA will need to rely on leading national regulators, including the FSA and its successors, to fulfil its tasks. We reiterate our view that day-to-day supervision of financial institutions should remain at a national level, and that an EU regulator should only have the power to intervene in exceptional circumstances. (para 85)

APPENDIX 1: EU SUB COMMITTEE ON ECONOMIC AND FINANCIAL AFFAIRS (SUB-COMMITTEE A)

The members of the Sub-Committee who conducted this inquiry were:

Viscount Brookeborough
Lord Dear
Lord Flight
Lord Hamilton of Epsom
Lord Harrison (Chairman)
Baroness Hooper
Lord Jordan
Lord Kerr of Kinlochard
Baroness Maddock
Lord Marlesford
Baroness Prosser
Lord Vallance of Tummel

Declaration of Interests

Viscount Brookeborough
Basel Holdings Ltd, Jersey, Investment Holding Company (non-trading)

Lord Dear
Non-executive Chairman, Blue Star Capital plc (investing in homeland security companies)

Lord Flight
Chairman, Aurora Investment Trust plc (investing primarily in equities mainly listed on the London Stock Exchange)
Chairman, Downing Structured Opportunities VCT 1 plc
Director, Edge Performance VCT plc
Chairman, EIS Association
Director, Investec Asset Management Limited (international investment manager)
Chairman, CIM Investment Management Limited (emerging markets investment manager)
Chairman, Arden Partners plc (stockbroker)
Commissioner, Guernsey Financial Services Commission (regulator)
Consultant, Kinetic Partners (investment management industry consultants)
Consultant, TISA (previously PIMA)
Shareholdings: Metro Bank plc (retail bank) and Arden Partners plc (stockbroker)

Lord Hamilton of Epsom
Non-executive Director Jupiter Dividend & Growth Trust PLC (Investment Trust)
Director IREF Global Holdings (Bermuda) Ltd (Property Fund)
Director IREF Australian Holdings (Bermuda) Ltd (Property Fund)

Lord Harrison
None relevant

Baroness Hooper
None relevant

Lord Jordan
Chairman, Homes and Communities Pension Scheme

Lord Kerr of Kinlochard
Director, Scottish American Investment Company Ltd (Investment Trust)
Member, Advisory Board, Edinburgh Partners (Adviser to a fund manager)

Baroness Maddock
None relevant

Lord Marlesford
Independent National Director, Times Newspapers Holdings Ltd
Director, Gavekal Research (Hong Kong)
Advisor to Sit Investment Associates (Minneapolis USA)
Owner of an agricultural estate in Suffolk with residential and commercial properties
As a farmer—payments are received through the EU CAP

Baroness Prosser
Director, Trade Union Fund Managers Ltd (company oversees investment of participating trade unions)
Trustee, Industry and Parliament Trust

Lord Vallance of Tummel
Member, Supervisory Board Siemens AG,
Member, International Advisory Board, Allianz SE

The following Members of the European Union Committee attended the meeting at which the report was approved:

Lord Boswell (Chairman), Lord Bowness, Lord Cameron of Dillington, Lord Dear, Baroness Eccles of Moulton, Lord Foulkes of Cumnock, Lord Hannay of Chiswick, Lord Harrison, Lord Maclennan of Rogart, Lord Marlesford, Baroness O'Cathain, Lord Richard, The Earl of Sandwich, Baroness Scott of Needham Market, Lord Tomlinson, Lord Trimble and Baroness Young of Hornsey.

A full list of registered interests of Members of the House of Lords can be found at http://www.parliament.uk/mps-lords-and-offices/standards-and-interests/register-of-lords-interests/

The Specialist Adviser to this inquiry, Professor Iain MacNeil, declared the following relevant interests:

ISA and SIPP (self-invested personal pension) investments in Aviva (in the form of General Accident preference shares)
Standard Chartered (preference shares)

APPENDIX 2: LIST OF WITNESSES

Evidence is published online at http://www.parliament.uk/hleua and available for inspection at the Parliamentary Archives (020 7219 5314)

Evidence received by the Committee is listed below in chronological order of oral evidence session and in alphabetical order. Those witnesses marked with * gave both oral evidence and written evidence. Those marked with ** gave oral evidence and did not submit any written evidence. All other witnesses submitted written evidence only.

Oral evidence in chronological order

*	(QQ 1–15)	Guy Sears, Investment Management Association (IMA)
**		Christian Krohn, Association for Financial Markets in Europe
**		Chris Bates, Clifford Chance
*	(QQ 16–32)	Thierry Philipponnat, Secretary General, Finance Watch
*		Dr Kay Swinburne, MEP, Member, European Parliament, Economic and Monetary Affairs Committee
**	(QQ 33–50)	Professor Niamh Moloney, London School of Economics
**		Professor Emilios Avgouleas, University of Edinburgh

Alphabetical list of all witnesses

**	Professor Emilios Avgouleas, University of Edinburgh
**	Chris Bates, Clifford Chance
**	Christian Krohn, Association for Financial Markets in Europe
**	Professor Niamh Moloney, London School of Economics
*	Thierry Philipponnat, Secretary General, Finance Watch
*	Guy Sears, Investment Management Association (IMA)
*	Dr Kay Swinburne, MEP, Member, European Parliament, Economic and Monetary Affairs Committee

APPENDIX 3: GLOSSARY

AIFMD	Alternative Investment Fund Managers Directive.
Algorithm	A process, or set of rules, usually one expressed in algebraic notation, now used especially in computing. In the context of financial markets, it takes the form of a mathematical formula which determines trading decisions.[126]
Algorithmic trading	A form of trading in which the decision to trade, its timing or terms (e.g. as to price) are determined by conditions specified in an algorithm. The objective is to enable market participants and investors to respond quickly (normally in an automated manner) to new information or market trends which are relevant for the price of financial instruments. It is a technique that is often used in high-frequency trading (HFT, see below).
Asset class	A category of financial instruments which shares common characteristics (e.g. equities, sovereign bonds, derivatives).
Best execution	A principle which requires an agent acting for an investor to execute transactions on the best terms available.
Bid-offer spreads	The difference between the prices at which a dealer will buy or sell a financial instrument. The spread is the profit margin of the dealer.
Bonds	Loans issued by legal entities or sovereign states with an agreed rate of interest and maturity date.
Broker	An intermediary who acts as the agent of investors for the purposes of arranging transactions in financial instruments.
Broker crossing network	A system operated by an investment firm which matches clients' orders outside organised venues (see below). Such systems were categorised as 'OTC' under

[126] See http://www.oed.com/view/Entry/4959?redirectedFrom=algorithm#eid.

	MiFID I but will fall generally within the new OTF category in MiFID II.
Buy-side firms	Firms which manage investment funds either on their own behalf or for clients. Also referred to as "investors".
Capital Adequacy Directive	EC Directive 2006/49 on the capital adequacy of investment firms and credit institutions. The Directive sets capital requirements for investment firms by reference to their 'trading book', which comprises all positions in financial instruments that are held with trading intent.
Central counterparties	An entity that legally interposes itself between counterparties to financial contracts, becoming the buyer to every seller and the seller to every buyer. A CCP performs a risk management function for its members by guaranteeing the performance of the legal obligations of buyer and seller.
Certificates	A document that evidences ownership of a financial instrument.
Circuit-breakers	Rules of organised markets that typically require trading in a financial instrument to be halted when prices become volatile by reference to pre-determined parameters.
Commodity derivatives markets	Markets (organised or OTC) in which derivatives contracts based on commodities are traded.
Consolidated tape	A mechanism which publicises post-trade information as to the prices and sizes of transactions in financial instruments which are executed on organised venues.
Counterparties	The parties to a contract. In a simple contract for sale, the seller and the buyer.
Corporate bonds	Bonds (above) issued by a corporate entity.
Dark pools	Generally, trading venues in which transparency is poor. Within the MiFID framework, the operation (by regulated markets, MTFs or investment firms) of trading venues with the benefit of waivers granted by

	national regulators from the pre-trade transparency obligations of MiFID.
Dark trading	Generally, trading in venues in which transparency is poor (including OTC).
Depositary receipts	Receipts issued by a legal owner of securities specifying that a depositary holds the securities as trustee for the depositary receipt holder. Often used as a technique to overcome the costs and regulatory barriers associated with foreign investment.
Derivatives	Financial instruments whose value is derived from an underlying investment or commodity. Can be used both to hedge risk and to speculate on the value of the underlying investment or commodity.
Dodd-Frank Act	The Wall Street Reform and Consumer Protection Act 2010 (US).
Electronic venues	Trading venues in which transactions are executed by means of electronic inputs from investors or their agents.
EMIR	The European Market Infrastructure Regulation, expected to enter into force in 2012 following adoption by the European Parliament in March 2012.
Equities	Shares in companies.
ESAs	European Supervisory Authorities.
ESMA	European Securities and Markets Authority.
Execution	The process by which client orders are carried out by investment firms.
Execution-only	Transactions executed by a firm upon the specific instructions of the client where the firm does not give advice on investments relating to the merits of the transaction.
Exchanges	Organised trading venues for financial instruments.
Exchange traded funds	Investment funds structured as listed companies.
Financial instruments	Investment-related contracts or documents of title. Also referred to as “securities”.

Firm quotes	Commitments to enter into transactions on specific terms.
Flash crash	A dramatic fall in US financial markets that took place in May 2010.
Front-running	A transaction for a person's own benefit, on the basis of and ahead of an order which he is to carry out with or for another, which takes advantage of the anticipated impact of the order on the market price. A form of market abuse (insider dealing) under the FSA's Code of Market Conduct.
FSA	Financial Services Authority.
G20	The group of industrialised countries and developing countries who play a major role in the world economy.
Hedging	The process of avoiding or mitigating risk through the use of financial instruments such as derivatives (see above).
HFT	High-Frequency Trading. A form of short-term trading that focuses on high-speed access to trading venues so as to benefit from small price differences and the division of large orders into smaller units. HFT traders often engage in algorithmic trading (above).
IOSCO	The International Organization of Securities Commissioners.
Level 1	EU directives (such as MiFID) which contain framework principles and which empower the Commission acting at Level 2 to adopt delegated acts or implementing acts.
Level 2	EU directives or regulations which represent the exercise of delegated authority under Level 1directives or implement such directives.
Liquidity	The availability and depth of a market for financial instruments. A measure of the potential to convert a financial instrument into cash.
Lit trading	Trading that is subject to public disclosure obligations.
MAD/MAR	Market Abuse Directive/ Regulation.

Market abuse	Various types of market conduct, in particular insider dealing and market manipulation, which are prohibited by the EU Market Abuse Directive and the Financial Services and Markets Act 2000.
Mark to market	Recording of financial instruments in the balance sheet of an investment firm at market value.
Market maker	A person who holds himself out on the financial markets on a continuous basis as being willing to deal on own account by buying and selling financial instruments against his proprietary capital and at prices defined by him.
Market operators	Persons responsible for the operation of organised venues (see below).
Market participants	Persons involved in a professional capacity in the transaction or execution of investment business. The term excludes "buy-side firms" (above).
MiFID	Markets in Financial Instruments Directive.
MTFs	Multilateral Trading Facilities, a form of organised market which may be operated by an investment firm and which is not subject to Title III of MiFID (rules applicable to regulated markets).
Non-equities	Any financial instrument other than equity (above).
Organised trading	Trading in standardised financial instruments according to the pre-determined rules of an organised venue.
Organised venues	Locations or systems through which organised trading occurs.
OTC	The 'over-the-counter' market, comprising trading which occurs outside organised venues, often in the form of non-standardised contracts concluded on a bilateral basis between counterparties.
OTFs	Organised Trading Facilities. A new category of organised venue defined by the recast MiFID regulation with the objective of extending transparency rules to execution techniques that are functionally

	equivalent to regulated markets and MTFs. The term encompasses broker crossing networks (above).
Own account	The use of a person's own capital to fund a transaction.
Own capital	A person or firm's own resources.
Passporting	The ability to establish a branch or offer investment services in another (host) Member State of the EU on the basis of an authorisation granted in an investment firm's home State.
Position limits	Restrictions on the holdings (long or short) of an investment firm in a financial instrument.
PRIPs	Packaged Retail Investment Products, which offer exposure to underlying financial instruments, but in packaged forms which modify that exposure compared with direct holdings (e.g. UCITS investment funds).
RDR	The Retail Distribution Review, launched by the FSA in 2007.
Regulated market	An organised trading venue that operates under Title III of MiFID.
Regulated venue	An organised venue that is a regulated market, MTF or OTF under MiFID II.
Retail investors	Investors who are not professional investors, primarily private individuals.
Shares	A share in the share capital of a company.
SIs	Systematic Internalisers, meaning investment firms which, on an organised, frequent and systematic basis, deal on own account by executing client orders outside a regulated market or an MTF or an OTF.
Smoking	A process whereby HFT traders post attractive limit orders to attract slow traders then rapidly revise these orders onto less generous terms, hoping to execute profitably against the incoming flow of slow traders' market orders.
Sovereign bonds	Bonds issued by a sovereign state.

Structured products	A product, other than a derivative, whose value is linked by a pre-set formula to the performance of an index, basket of securities or other conditions.
Third country	A country outside the European Union.
Trades	Transactions in financial instruments.
Two-way prices	An offer to buy or sell at specified prices. The 'bid-offer' spread (above) is the difference between the two prices.
Underwriting	A commitment to buy financial instruments that cannot be sold as part of a public offer.
Venues	See organised and regulated venues above.
Volume	A measure of the scale of transactions in a particular security or market.
Wholesale market	The financial market other than the retail market (see retail investors above).
WTO	World Trade Organization.

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