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FIA Europe
MiFID II advocacy points

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Overview

- Indirect Clearing
- Straight-through Processing
- Commodities
- Non-discriminatory Access to Trading Venues, CCPs and Benchmarks
- Transparency
- Market Data and Reporting
- Organisational Requirements for Investment Firms
- Organisational Requirements for Trading Venues
- Market Making
- Order to Transaction Ratios
- Co-location and Fee Structures
- Tick Sizes
- Clock Synchronisation
- Execution of Orders

Indirect Clearing

- Indirect clearing arrangements are already a key part of the ETD market operating model
- Current proposal would jeopardise access to markets for ETD end users, reduce liquidity and increase market risk;
- Jurisdictional scope: limit to EU CCPs and EU indirect clients
- Potential conflicts of law where direct clients are not located in EU
- Default Management Process – clarify that:
  - the clearing member is only required to return assets/liquidation proceeds to indirect clients that have selected GOSA accounts. If CM unable to effect such a return, then clearing member must be able to make payment to the insolvent direct client, for the account of the indirect client;
  - for NOSA clients, the clearing member is expected to have a robust procedure to liquidate the portfolio and return asset to the direct client for the account of the indirect clients; and
  - direct client only has to include in its agreement with the indirect clients terms that facilitate a “leapfrog” payment if that indirect client opens a GOSA.
- Scalability and implementation challenges – market upheaval should not be underestimated
- The direct client should be able to select a NOSA for the indirect client as the default position in the absence of a response from indirect client as to their preferred account type
- Risk management obligations on the clearing member need to be workable
- The first 4 members of the clearing chain must comply with the RTS, even if the chain of relationships is longer that CCP-Clearing Member-Direct Client-Indirect Client
- Cost/benefit analysis remains outstanding

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Straight-through processing

- Pre-execution checks should not be required for ETD as, in contrast to the OTC clearing market, there is already certainty of clearing of ETD via the binding contractual arrangements of the trading venue and CCP rulebooks.
- Introduction of pre-execution limit checks would cause significant disruption to ETD markets.

Commodities

Ancillary activities

- ESMA should provide market data for the trading activity test
- concerns regarding the impact on group companies that do not engage in MiFID II activities

Position limits and position reporting

- Deliverable supply is the right metric for the spot month, but other months should be measured against open interest
- How do you determine "deliverable supply"?
- For non-spot month contracts, introduce de minimis thresholds before applying position limits, to permit contract growth
- Definition of netting is too narrow: one should be able to net physical positions
- ESMA should allow disaggregation of independently managed business to which legal information barriers apply
- ESMA should have regard to CFTC form 40 rules, which mitigate data privacy issues by enabling end user to send relevant information directly to the CFTC without passing through a chain of intermediaries, to protect client confidentiality and mitigate conflicts with national privacy laws.

Non-discriminatory access

- Two contracts should be considered "economically equivalent" for netting and collateral purposes only if they are "significantly and reliably correlated, or based on equivalent statistical parameters of dependence, with the price risk of one another" – we propose that "significantly" be construed as 90% correlated over the relevant assessment period
- It should be possible to reject an access request in part, not just in whole
- A CCP must not be required to clear contracts outside its EMIR authorisation and/or that it does not currently clear
- Split views on the extent to which significant undue legal risks should permit denial of access
- Trading venues should be able to deny access as a result of certain significant undue legal risks
- "Non-discriminatory" fees/collateral processes/netting processes ≠ "the same" fees/collateral processes/netting

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Transparency

- Avoid a one-size-fits-all approach
- COFIA approach means that some classes, especially equity derivatives and commodity derivatives, are insufficiently granular - those asset classes do not appear to have been subject to the same rigorous assessment as interest rate derivatives. Accordingly, the analysis and liquidity determinations for equity and commodity derivatives may require complete overhaul
- Interest rates are sufficiently granular as a class, but some further granularity required for some instruments, particularly swaptions
- In some cases, incomplete data sets (e.g. not covering global markets) or wrong data sets (e.g. post-trade data rather than order-book data) were used to assess whether certain sub-classes of instruments have liquid markets – we request that ESMA use the appropriate pre-trade order book data sets from the relevant trading venues
- Large In Scale (LIS) and Size Specific To Instrument (SSTI) thresholds are not adequately calibrated – some are too high, others too low.
- ESMA should consider the appropriate application of pre- and post-trade transparency obligation to package transactions

Market data and reporting

- Clarify:
  - what should be reported in the event of early ETD Option exercise
  - whether "lapsed" client LEIs can be reported
- "Transmission of order" will be challenging to implement, due to the volume of trades in the ETD asset class
- For ETD, ESMA differentiates client from house business using the term "Matched Principal". For ETD, the proposed interpretation of the word "simultaneous" is problematic
- A further reportable field is needed, to capture optionality for certain ETD contracts under which a range of underlyings are deliverable

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Organisational req'ts for investment firms

- "business continuity" requirements should be replaced by "disaster recovery" arrangements leading to controlled wind-down: contrary to market practice (avoiding "hot failovers") to require firms to run two sets of hardware
- Non-live testing requirements should apply to investment firms, not trading venues, as this would be more effective and cost-efficient: avoid a tick-the-box approach to compliance
- To require all investment firms to conduct annual stress testing is disproportionate
- Certain risk monitoring cannot realistically take place in real time as defined by ESMA (particularly credit checks)
- We suggest modifications to the procedure for DEA due diligence to introduce a risk-based approach and to rely, where possible, on self-assessments prepared by DEA clients
- We strongly disagree with any requirements dictating the content of commercial agreements between investment firms and their vendors – the key is to ensure that investment firms are ultimately liable for compliance with their obligations and they must ensure that if they outsource, they remain in compliance with their regulatory obligations

Organisational req'ts for trading venues

- Trading venue requirements often duplicate the requirements on investment firms: costly and resource-intensive
- Trading venues should be able to apply a risk-based approach regarding the annual assessments when deciding the level of scrutiny to apply to each member
- We propose that we work with the trading venues and their members to develop a standard industry approach to dealing with compliance with the due diligence standards
- Trading venues' capacity: venues should be able to manage a gradual degregation in system performance when the message load on their trading systems increases to twice the historical peak and beyond (only where doubling of historical peak is plausible)
- Conformance testing involving technical and functional capabilities should be limited
- We propose that ESMA should leave the non-live testing against disorderly trading conditions to investment firms and not trading venues
- For stress tests, we propose a specific market condition in place of "random combination of market conditions" and have removed the reference to fining of trading venue members
- Volatility should not be considered detrimental to the interests of market participants unless it creates disorderly trading conditions
- Circumstances in which kill functionality should be activated should include disconnect and log-out from trading system. GCMs should have access to such functionality for their NCMs as well as members providing sponsored access

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Market Making

- The minimum presence threshold at which an investment firm should be deemed to be pursuing a market making strategy should be symmetric with the minimum presence threshold at which it would be obliged to quote under a market making strategy, i.e. 50% (not 30% followed by 50%, as proposed by ESMA), to avoid capturing investment firms that do not intend to operate as a market maker
- ESMA's proposed definition for 'competitive prices', meaning "quotes posted within the average bid-ask spread", is unworkable:
  - "average" is vague. Further, not only must it be calculated intra-day but it will also move more quickly than market makers will be able to adjust
  - Because market makers cannot quote continuously within any such spread, we are concerned that "average" will be construed as best bid offer (BBO). Current market practice is to quote within a fixed range of BBO, adjusted for the liquidity of the instrument
  - Instead, we propose to redefine RTS 15(7) in accordance with ESMA's short selling regulation guidelines on the market making exemption – "competitive prices should be within the maximum bid/offer spreads that are required from the market makers/liquidity providers recognised under the rules of the trading venue where they are posted for the concerned instruments".
- We agree with the introduction of extreme volatility as an exceptional circumstance but consider the proposed wording to be too restrictive, in that it requires an interruption of trading with respect to *all* instruments traded on a venue
- Quoting in stressed market conditions should remain at the discretion of the investment firm

Order to Transaction Ratios

- We propose that new venues may reassess OTRs on a regular basis as liquidity develops
- We suggest that ESMA make explicit the trading venue's ability to establish derogatory arrangements for instruments for firms engaged in market making agreements related to that instrument – professional market makers will necessarily have higher messaging rates that other participants
- Trading venues must be in control of setting the maximum permitted ratios of unexecuted orders to transactions – we understand that it is ESMA's intent to specify a formula for trading venues to use in calculating OTRs rather than to specify a calculation of the maximum OTR
- Any OTR regime should include a floor, below which no breach will be deemed to have occurred – this is necessary to account for illiquid instruments as well as to emphasise the actual system load generated through messaging
- We suggest determining a max ratio annually but permitting trading venues to make ad-hoc adaptations during periods of high volatility

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Co-location and fee structures

- We agree that all users should have non-discriminatory access to co-location services and that conditions and pricing be transparent
- While cliff-edge pricing has been banned, we consider that trading venues may be able to offer threshold-based incentives to members or participants that enter into a market making agreement
- We object to the ability of trading venues to pass through costs of conformance testing to investment firms, on the grounds that this has no basis in the primary legislation and the requirement to test at the venue is a mutual obligation for investment firms and trading venues, for which each type of market participant should be its own direct costs
- Our members are concerned that the EU remains non-competitive on cost compared with other markets such as the US and Asia-Pac

Tick sizes

- The market has had insufficient time and access to data to perform the thorough analysis needed to answer the questions fully, but estimate that over 75% of European instruments will trade under a new tick size because of ESMA's proposals, resulting in temporary market dislocation and significant volatility
- While there is no possibility of a 'pilot programme', we propose ESMA increase the frequency of its annual review to semi-annual and that national competent authorities may intervene and temporarily derogate from the new tick size in case of degradation of market microstructure with a notification requirement to ESMA
- We are not aware of any instances of disorderly functioning of the markets that have been caused by inappropriate tick sizes in European markets
- The average number of trades per day on *all European trading venues* should be considered, rather than just looking at the most relevant market in terms of liquidity

Clock synchronisation

- The requirement to calibrate to a maximum divergence of 1 nanosecond for certain trading venues and investment firms is vastly excessive and does not reflect currently available technology – the most precise synchronisation protocol (PTP) today achieves only an accuracy of 20-100 nanoseconds. We believe that 1 microsecond granularity (generally) and 100 micro-second accuracy (for HFT firms) will meet ESMA's objectives, while ensuring that inappropriate costs are not incurred by large financial participants
- We do not support ESMA's suggestion to link clock synchronisation requirements for investment firms directly to the trading venues on which they trade, because this will excessively impact non-latency sensitive firms that trade on venues also catering to latency-sensitive clients; rather, we propose that ESMA sets out two standards for investments: one general and one more granular requirement for HFAAT firms based on the MiFID II definition. In case ESMA does not accept this, we propose a 'plan B' whereby firms can simply adopt the time stamp generated by trading venues
- We suggest less variance in the granular bands for the trading venue gateway-to-gateway latency table, which as currently proposed increase by a factor of 1,000, with correspondingly sharp increases in technology cost and implementation difficulty

Execution of orders

- We support AFME's response to RTS 6 and 7
- Specifically, we consider that the current proposals:
  - Do not differentiate adequately between different trading systems
  - Could lead to the disclosure of commercially sensitive information
  - Are duplicative
  - Could have a detrimental impact on client confidentiality

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