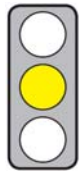


## KEY ISSUES

**Objective of the Directive:** The Commission strengthens the regulation of trading venues, the surveillance of financial instruments trading and investor protection.

**Parties affected:** Investors, investment firms, trading venues, supervisory authorities.



**Pro:** (1) Classifying certain trading platforms as OTF trading venues, which have hitherto been acting off-exchange, eliminates distortion of competition.

(2) Position limits determined by trading venues enhance market functionality.

**Contra:** (1) Energy producers and companies which hedge risk positions by means of commodity derivatives should not be treated as financial service providers subject to authorisation.

(2) Conferring upon investment advice services the title “independent” is the wrong approach. The Commission should either accept the preferences of investors in favour of commission-based consultation, or increase the transparency requirements for commissions.

(3) Position limits fixed by the Commission bear the risk of political opportunity.

## CONTENT

### Title

**Proposal COM(2011) 656** of 20 October 2011 for a **Directive** of the European Parliament and of the Council **on markets in financial instruments (MiFID)** repealing Directive 2004/39/EC of the European Parliament and of the Council (recast).

### Brief Summary

#### ► General and objectives

- Together with the Regulation [COM(2011) 652, hereinafter: Regulation, see [CEP Policy Brief](#)] the Directive establishes the legal framework for “the provision of investment services” (Explanation p. 1).
- The existing MiFID Directive (2004/39/EC) is partly recast by this Directive and partly replaced by the Regulation (Recital 7, Art. 98).
- The Directive contains provisions on the trade venues and the trading carried out at said venues, on investor protection and the possibilities for intervening in trading (position limits and position management).
- The objective of the Directive is to make EU financial markets more transparent and more efficient, to improve investor protection and to strengthen supervision (Explanation p. 1 and 6, Recital 4).

#### ► Trade venues

- The Directive and the Regulation make a distinction between three “trading venues” (Art. 2 of the Regulation):
  - Regulated markets (RM) are traditional, statutorily authorised stock exchanges.
  - Multilateral trading facilities (MTF) are trading systems which resemble the stock exchange and are subject to less strict requirements e.g. for the authorisation of financial instruments.
  - Organised trading facilities (OTF) are trading systems which are not considered MTF or RM and in which purchase and sales interests are brought together in an organised, often automated manner. First they are classified as a “trading venue” and then are subject to stricter transparency rules than before (for details see CEP Policy Brief on the Regulation).  
OTF include in particular broker crossing networks operated by investment firms using “internal electronic matching systems” to bring together mutual interests (Recital 7 of the Regulation).
- RM, MTF and OTF bring together the interests of a number of purchasers and sellers of financial instruments. RM and MTF have, however, unlike OTF, no discretionary powers when it comes to bringing together client orders. (Art. 2 (5), (6), (7) of the Regulation)

#### ► Scope

- The Directive regulates the activities of investment firms, credit institutions and trading venues (Art. 1 (1) and 3).
- For instance, the Directive does not apply to:
  - insurance companies (Art. 2 (1) lit. a);
  - persons acting on their own account, unless they do so on behalf of client orders or are members or participants of an RM or MTF (Art. 2 (1) lit. d and i);
  - persons trading on their own account as members or participants of an RM or MTF with commodity derivatives or emission allowances, if this trade is only an ancillary activity and the company group does not provide banking or investment services as their main business (Art. 2 (1) lit. d and i); the Commission defines in delegated acts which activity is considered an ancillary activity (Art. 2 (3)).

- Emission allowances are included in the Regulation as a new “financial instrument” (Recital 9, Annex I, Part C, No. 11).

► **Provisions on the authorisation of trading venues**

- Regulated markets are subject to authorisation by national supervisory boards (Art. 47).
- The operation of an MTF or OTF is considered an investment service (Annex I Part A No 8 and 10, Art. 2 (6) and (7) of the Regulation). Therefore, the operator must comply with the authorisation rules for investment firms and the provisions on their activities (Art. 5 (1) and 2, Title II).

**Organisational requirements**

- The organisational requirements as to trading venues are almost identical (Explanation p. 6). For instance, all trading venues must establish transparent and fair rules for trading and transparent criteria for providing access to financial instruments (Art.18 (1-3), Art. 50 lit. d, Art. 52 (1)).
- Unlike RM and MTF, OTF:
  - may waive the rules to prevent conflicts of interest between the trading venue and its owners or operators (Art. 19 (3), Art. 50 lit. a);
  - are free to choose their members and actors participating in their trading venue (Art. 19 (2), Art. 55 (3));
  - must not use own capital when carrying out client orders in order to maintain their neutrality regarding all deals (Explanation p. 7, Art. 20 (1)).

**System resilience**

- RM and MTF must ensure that:
  - their trading systems are “resilient” and have sufficient capacity to ensure “orderly trading” under conditions of market stress (Art. 51 (1), Art. 19 (4));
  - the algorithmic trading systems cannot create or contribute to “disorderly trading conditions on the market” (Art. 51 (3), Art. 19 (4)).
- RM and MTF may reject client orders and halt trading if there is a “significant price movement” only where such orders exceed pre-determined “volume and price thresholds” (Art. 51 (2), Art. 19 (4)).
- These rules only apply to OTF operators if they allow the automated trading to take place over their systems (Art. 20 (4)).

► **Rules for trading on trading venues**

**Automated (algorithmic) trading**

- In automated trading, computer algorithms automatically determine the timing, price and volume of trading carried out with financial instruments (Art. 4 (30)).
- Investment firms and credit institutions dealing with automated trading must for instance (Art. 17):
  - have “sufficient” capacity and “appropriate” trading thresholds and limits;
  - be able to deal with unforeseen market disruptions (e.g. through the conveyance of incorrect orders);
  - inform the competent authority at least annually of their trading strategies and control systems;
  - check the suitability of the user of direct electronic access to the trading venue, where such access is provided.
- The computer algorithm used by a trader (i.e. its algorithmic trading strategy) must be constantly in use during trading times and provide trading venues with liquidity at all times, “regardless of prevailing market conditions (Art. 17 (3)).

**Suspension or removal of financial instruments from trading**

- Operators of an RM, MTF or OTF may choose to remove or suspend a financial instrument from trading. Operators must publish such decisions and inform other trading venues that trade with the same financial instrument and the competent national authority. (Art. 32 (1), Art. 33 (1), Art. 53 (1))
- If an RM or MTF operator suspends a financial instrument due to “the non-disclosure of information” on issuers or the financial instrument, national supervisory authorities must “require” the suspension or removal of the instrument concerned from other RM, MTF or OTF, too. This rule does not apply where investor interests or the “orderly functioning of the market” might be seriously harmed. (Art. 32 (1), Art. 53 (1) sub-para. 2)

► **New investment protection provisions**

- In order to protect “non-professional” investors when being consulted and when carrying out orders, the Directive contains particular obligations regarding client information, the review of the suitability of an investment and the cost-effective carrying out of orders (Art. 24, 25, 27 and 28 in conjunction with Art. 30 (1)).
- Investment firms and credit institutions offering investment advice services must inform their clients as to whether they do this on an “independent” basis, how comprehensive their market analyses are and whether the suitability or the recommended financial instrument is constantly assessed (Art. 24 (3)). “Independent” advice is only given if the institution “assesses a sufficiently large number” of financial instruments on the market and if it does not receive “fees, commissions or any monetary benefits” paid by third parties, in particular by the issuers of the financial instruments (Art. 24 (5)).
- For portfolio management, investment firms and credit institutions must not accept any commissions. (Art. 24 (6)).

### ► Field of intervention in trading

#### Position limits in commodity derivatives

- Commodity derivative contracts are contracts whose value is derived from a commodity (e.g. wheat).
- Trading venues offering trading with commodity derivatives must determine limits or equal rules for the number of contracts with commodity derivatives which a single market participant may enter into in a given period of time (Art. 59 (1)). These limits can vary, depending on the market participant. They must be transparent, non-discriminatory, specify their volume thresholds and be adjusted to the characteristics of the underlying commodity market (Art. 59 (1)).
- In setting legally binding limits by means of delegated acts that apply to all participants, the Commission takes into account the said limits (Art. 59 (3)). In exceptional cases, national supervisory authorities may set stricter limits (Art. 59 (4) sub-para. 1).

#### Position reporting and management of commodity derivatives and emission allowances

- Where trading venues offering trade with commodity derivatives or with emission allowances exceed a certain threshold, they must make public on a weekly basis the “aggregate positions” held by the different categories of traders (e.g. insurance companies, investment funds). The Commission determines the thresholds by means of delegated acts. (Art. 60 (1) lit. a, sub-para. 2, (5))
- The participants of a trading venue must report to the trading venue “the details of their positions in real-time”, including any positions held on behalf of their clients (Art. 60 (2)).
- The national authority may demand information from any person regarding the “volume and purpose” of a position entered into via a derivative (Art. 71 (2) lit. i).
- The national authority may ask any trader to reduce “the size of a position” (Art. 72 (1) lit. f).
- Through the Regulation (see CEP Policy Brief) the ESMA also obtains the power to request that single persons reduce the size of positions entered into via a derivative (Art. 35 Regulation).

### Changes to the Status quo

Certain trading platforms such as the Broker Crossing Networks are no longer considered off-exchange but are assigned to the new trading venue category “OTF”. This is the first time that they are subject to pre-trade transparency rules. For the automated trade, protective measures are prescribed. To this end, a concept of independent advice is to be introduced. The supervisory authorities receive enhanced powers to intervene in the trade with derivatives.

### Statement on Subsidiarity by the Commission

Investment service providers and trading venue operators need EU-wide harmonised requirements. Otherwise there is the threat of efficiency losses, a “fragmentation of markets”, distortion of competition and regulatory arbitrage.

### Policy Context

In June 2009, the EcoFin Council undertook to improve the transparency and the surveillance of the less regulated markets, in particular of the off-exchange trading. In September 2009, the G20 also agreed to improve the regulation of commodity markets. The Proposal complements the Regulation on OTC Derivatives [COM (2010) 484, see [CEP Policy Brief](#)]. Along with the MiFID Proposal, the Commission published new market abuse rules [COM (2011) 651 and COM (2011) 654, see [CEP Policy Brief](#)].

### Legislative Procedure

20 October 2011 Adoption by the Commission  
 Open Adoption by the European Parliament and Council, publication in the Official Journal of the European Union, entry into force

### Options for Influencing the Political Process

Leading Directorate General: DG Internal Market  
 Committees of the European Parliament: Economic and Financial Affairs (leading), rapporteur: Markus Ferber (EEP Group, DE); Legal Affairs; Development; Industry, Research and Energy  
 Committees of the German Bundestag: Finances (leading); Economy; Consumer Protection; Economic Cooperation and Development; EU Affairs  
 Decision mode in the Council: Qualified majority of the Member States and 255 of 345 votes; Germany: 29 votes)

### Formalities

Legislative competency: Art. 53 (1) TFEU (Freedom of Establishment)  
 Form of legislative competency: Shared Competency (Art. 4 (2) TFEU)  
 Legislative procedure: Art. 294 TFEU (ordinary legislative procedure)

## ASSESSMENT

### Economic Impact Assessment

**It is appropriate to introduce the OTF as a new trading venue category which is subject to a regulation similar to that of RM and MTF.** To date, OTF have acted quasi as free riders: they contribute to the market pricing mechanism only to a limited degree (see CEP Policy Brief on the Regulation) but nevertheless use the information on prices and trade interests which RM and MTF provide. This has created a one-sided competitive advantage for OTF. The fact that these new rules provide OTF with more transparency regarding the purchase and sales interests of market participants should be in their own interests. A further shifting of trading activities towards off-exchange acting platforms would undermine the validity of the prices derived from regulated markets and thus jeopardise the business model of OTF.

Classifying emission allowances as financial instruments increases the transparency of such allowance trading.

**Energy producers** – which under EU law are obliged to acquire such allowances – **and companies hedging their risks by means of commodity derivatives should**, however, **not** fall under the scope of this Directive. For then they would have to **be considered as financial service providers subject to authorisation**. Their activities have nothing to do with the banking business and the associated questions regarding systemic risks and investor protection. This should be made very clear in the Directive. For until now it has been especially unclear which activities exactly are deemed “ancillary activities” and are therefore exempted from the Directive.

**The introduction of the title “independent”** for consultants who do not receive any commission from third parties and review a “sufficient” number of financial instruments **is a subtle promotion of fee-based consultation**. Hence, the Commission seemingly does not accept the fact that the majority of investors choose the service of commission-based consultation instead of fee-based services. They do so despite the fact that comprehensive rules exist regarding the disclosure of commission-based consultation. Therefore, the Commission should accept the preference of investors in favour of a commission-based consultation; or they should propose additional rules to increase transparency if it thinks that consumers are not able to take investment decisions themselves on the basis of sufficient information. **Apart from that, it remains open as to whether the quality of fee-based consultation** that “assesses” a “sufficient” number of financial instruments **is actually better than commission-based consultation**. Where clients pay less, an “independent” consultant will not analyse the large number of financial instruments in a way that is of high quality and covers all costs.

**Position limits determined by trading venues can prevent market manipulation.** This strengthens the functionality of trading venues and the credibility of price formation. The competition between trading venues prevents inappropriate limits. **Position limits fixed by the Commission**, however, **carry the risk of political opportunity**. The Commission could try to steer economically justified but politically undesirable price trends on the commodity markets. This would distort prices and caused the misallocation of capital.

The power of authorities to demand the reduction of entered positions (“position management”) can sanction misconduct. Such a massive intervention into free trade must, however, be based on objective and non-discriminatory criteria. The maintenance of many contracts does not constitute market abuse per se. The fact that both national authorities and the ESMA may manage positions, increases uncertainty and runs the risk of politically motivated conflicts.

### Legislative Assessment

#### Competency

Art. 53 (1) TFEU (self-employed activities) is the relevant legal basis

#### Subsidiarity

Unproblematic.

#### Proportionality

Depends on how the delegated acts are actually shaped.

#### Compatibility with EU Law

Unproblematic.

#### Compatibility with German Law

Amendments in the Exchanges and Securities Trading Act will be necessary.

### Conclusion

Classifying trading platforms as OTF trading venues, which to date have acted off-exchange, eliminates the distortion of competition. Energy producers and companies which hedge their risks by means of commodity derivatives should not be treated as financial service providers subject to authorisation. With the title “independent” the Commission promotes commission-based consultation. Position limits determined by trading venues enhance market functionality; if fixed by the Commission, they bear the risk of political opportunity.