

EUREX

# MiFID Review: A How Does It Affect You?

Randolf Roth and Vassiliki Veliou of Eurex look at the issues arising for the quant community from the EU Commission review of MiFID

As much as we all like to concentrate on trading rather than politics and regulation, the latter sets out the framework for the future market structure and thus offers every trader the opportunity to trade. Currently, the EU Commission (EC) is reviewing the Markets in Financial Instruments Directive (MiFID), which became applicable in November 2007. Broadly, this directive regulates provision of investment services in relation to all financial instruments including derivatives, and it affects all financial market participants (exchanges, alternative trading venues, investment firms, and OTC market participants). A recent EU Commission public consultation on the MiFID review foresees a number of changes in the market structure, trade transparency, market data consolidation, microstructural issues (high-frequency trading, tick sizes, co-location), and other MiFID areas.

## European market structure

MiFID had a significant impact on the European equities market structure. Accordingly, market structure topics play a prominent role in the

ongoing MiFID review. The upcoming MiFID amendment intends to address some of the shortcomings in terms of market structure problems in equities markets as well as giving thoughts to the existing derivatives market structure. As this article focuses on the derivatives markets, we like to discuss the most significant topics of derivatives market structure regulation for the quantitative trading community: organized trading facilities (OTFs) and regulation of high-frequency trading (HFT) firms.

## Organized trading facilities – a new trading venue category

Currently, MiFID differentiates between three different trading venues

- regulated markets (RMs)
- multilateral trading facilities (MTFs)
- systematic internalizers (SIs)

whereas the remaining trading activity is subsumed under OTC.

While the three categories are attached to market rules such as organizational requirements, transparency, or surveillance by MiFID, there are a great number of marketplaces, which cannot be associated

with any regulation as a trading venue. Apparently, the EC aims to reduce substantially the number of marketplaces which are exempt from its market regulation. As it specifically wants to include OTC derivatives markets organized by Inter-Dealer Brokers (IDBs), across all means of trading including voice broking, the EC feels the need for an additional trading venue category, the OTF.

The way OTFs are currently defined means that the most significant difference between an OTF and an MTF is the OTFs' ability to arrange trades on a discretionary basis, as this is usually the case with telephone trading. However, an OTF would as well need to fulfill certain pre- and post-trade requirements similar to those applicable to MTFs. In addition, the EC proposes to convert all OTFs to MTFs, once these venues attain a certain volume-based threshold. In other words, once a market has grown to a certain size, it should obey advanced market structure requirements.

We welcome this development, as we believe it will create additional liquidity and provide new trading opportunities, especially for the quantitative trading community. One example is the off-exchange market in Eurex options: the proposed legislation would create an environment with pre- and post-trade data not only published by Eurex, but also by all other marketplaces arranging trades in these options. Consequently, trading would become significantly easier for quantitative firms in these options, because market participants would finally have access to the whole pricing picture. A second example would result from the requirement of an OTF being transformed into an MTF, once it has

reached certain thresholds, which will make more products available to the quantitative trading community.

### Potential HFT regulation - new challenges

The second subject of relevance is the potential regulation of HFT firms. So far, there is only a very vague definition in the MiFID consultation of what a high-frequency firm<sup>1</sup> actually is. Nonetheless, the EC discusses that all persons involved in HFT-trading above a certain threshold, would need to be authorized as investment firms. Furthermore, it considers a number of measures to be enforced by market operators

such as:

- HFT firms need to fulfill market maker requirements
- introduction of minimum resting periods for orders
- all participants need to obey certain order-to-trade-ratio limits

It is fair to say that those potential measures have been rejected across the industry. In the meantime ESMA, the new regulatory authority in charge of supervising European securities markets, and the EC continue to look for a quantifiable definition of HFT firms. In our view, this will not be successful as HFT is not a strategy but a technology which is used for a broad spectrum of trading strategies and has been in the marketplace for

quite some time. Overall it seems like the upcoming legislation will not be as harmful as it may have looked six months ago, as the regulator is clearly showing an increasing awareness of the unintended consequences (e.g., reduce liquidity of markets) that an ill-designed HFT regulatory regime would have. It appears that the regulator turns the focus to the more appropriate topic of market abuse detection.

### Transparency

The core objectives MiFID indisputably pursues are market efficiency and market integrity, by constituting a fairness principle in European

- pre-trade transparency requires RMs, MTFs, and SIs to publish orders and quotes;<sup>2</sup>
- post-trade transparency requires RMs, MTFs, SIs and investment firms (IFs) executing trades OTC to publish a trade report when a transaction has been concluded.<sup>3</sup>

In the MiFID review, the EC discusses points for improvement of the current transparency regime for equities, but also proposes an extension to encompass various non-equities asset classes, including derivatives. We welcome the suggestions put forward in the consultation document with regards to deriva-

## The market structure and classification of venues laid down by MiFID were supposed to result in innovative and competitive – but leveled – markets

financial markets. The market structure and classification of venues laid down by MiFID were supposed to result in innovative and competitive – but leveled – markets. The most important ingredient to level the playing field in a competitive and fragmented landscape is transparency. This prerequisite provides the source to supply valuable information to the market and thus the influx for increased liquidity, vital to the majority of quantitative oriented market participants.

Basically, the MiFID transparency regime, currently applicable to equities markets only, requires trading venues and investment firms to adhere to pre- and post-trade transparency rules:

tives markets, as these appear to pursue the creation of a fair and level playing field for the whole European derivatives markets, regardless of the type of trading venue. Clearly, market transparency is absolutely crucial for healthy financial markets. By shedding light on the less transparent segment of the derivatives space, the following benefits can be envisaged:

- OTC data would be required to be published in a meaningful, and non-aggregated way;
- pre-trade transparency for transactions subsumed under MiFID regulated venues; for large sizes, a large in scale waive can be envisaged;



## EUREX

- timely post-trade reporting, along uniform, regular, and consistent standards;
- fair and leveled competition;
- transparency is also a crucial

EC suggests extending the scope of instruments under observation to derivatives, including pure OTC derivatives transactions, which is reasonable given the interlinkages

### Outlook: Micro-structural issues

In parallel with the MiFID review-process, ESMA has started to look at market microstructural issues by initiating a

- co-location/proximity service – ensure non-discriminatory access for all interested parties;
- latency of marketplaces – create standards for measuring latency;
- circuit breakers – analyze the coordination of circuit breakers across relevant European markets in a systemic event.

We expect the legislative amendment proposal for MiFID to be published in autumn 2011 by the EU Commission with finalization of the rule set potentially by the end of 2012. As the review is expected to consist of a directive and a regulation, European member states will need to transpose the directive into national laws, whereas the regulation becomes directly applicable law in the EU.

For further information, please visit [www.eurexchange.com](http://www.eurexchange.com)

## Currently, these non-authorized firms do not report transactions, but in the future, it is envisaged that trading venues like Eurex report on their behalf

pre-condition for the functioning of the envisaged OTF category, including its threshold concept;

- increased liquidity due to increased transparency, and hence more trading opportunities.

### Regulation of market participants and transaction reporting

MiFID requires supervisors to monitor the activities of investment firms (IFs) for abuses as defined under the Market Abuse Directive (MAD). Therefore, IFs currently need to report all transactions in all financial instruments which are admitted to trading on a regulated market to the respective competent authorities, regardless of whether the trade takes place on that regulated market or not. For example, if transactions in listed shares take place off-exchange, those need to be reported to the supervisor. In contrast, pure OTC transactions do not need to be reported. This gap is currently addressed in the consultation, and will be closed in the future.

Within the MiFID review, the

of regulated markets and OTC traded products, e.g., swaps and listed products in an asset class. It is further suggested to extend transaction reporting obligations to trading venues (RMs, MTFs, OTFs) that offer access to firms not authorized as IFs or credit institutions, such as for example HFTs which do not provide any investment service other than dealing on own account.

Currently, these non-authorized firms do not report transactions, but in the future, it is envisaged that trading venues like Eurex report on their behalf, if exchange product related transactions have been concluded. In case of pure OTC transactions, reporting will be safeguarded through Trade Repositories, as described under the European Market Infrastructure Regulation (EMIR). To provide you with a practical example: at Eurex, 19 percent of the volume is currently generated by firms that are not authorized as IFs under MiFID. Hence, the supervisor would receive a more complete picture of the market, without imposing reporting obligation on, for example, HFTs dealing on their own account.

fact-finding and consultation process. The relevant topics for the quantitative trading community include:

- HFT, as discussed above;
- market access – identify potential issues with sponsored access and/or DMA and most likely banning naked access;

### About the Authors

Randolf Roth has a PhD in Financial Engineering from Dresden, University of Technology. He joined Deutsche Börse Group in 1999 as a key account manager in the London office. In 2000 he moved for Eurex to Chicago, where Eurex implemented jointly with the Chicago Board Of Trade (CBOT) their first fully electronic trading system. Thereafter, Randolf Roth continued to work for Eurex in Chicago, heading various US business development projects. In 2004 he moved to Deutsche Börse/Eurex headquarters in Frankfurt where he currently serves Eurex as Executive Director, Head of Market Structure.

Vassiliki Veliou attained the Master in International Business from the University of Maastricht, The Netherlands. Vicky joined Eurex in 2006, taking on responsibilities in the field of market development, and later in corporate strategy. Since last year she further expands her field of activities in the section Clearing Initiatives, focusing on various regulatory topics impacting the derivatives and clearing space.

### FOOTNOTES

1. The MiFID public consultation document has a very broad definition of “automated trading” and states then: „High frequency trading would be considered a subcategory of automated trading.” Cf. European Commission (2010): Public Consultation. Review of the Markets in Financial Instruments Directive (MiFID).
2. There are four waivers from pre-trade transparency for equities market, a) large-in-scale (LIS), b) reference price, c) negotiated transactions and order management facilities. We could imagine that especially the LIS waiver can be applied in derivatives markets.
3. Market participants require reliable, timely, and available information at a reasonable cost. Some have expressed concerns relating the timing of publication, and supervisors agree that the maximum permitted delays should be reduced.