LEBA WMBA

London, 13th January 2012

Review of the Markets in Financial Instruments Directive
Questionnaire on MiFID/MiFIR 2 by Markus Ferber MEP

Response of WMBA

By email to econ-secretariat@europarl.europa.eu

The members of the Wholesale Market Brokers Association ("WMBA") welcome this opportunity to respond to the questionnaire issued on behalf of the European Parliament.

Given the absolutely vital addition of a new category of Organised Trading Venue under MiFID 2 and MiFIR and its direct impact on the domain expertise of our member firms, the WMBA's responses will focus on those matters within the questionnaire that relate directly to Organised Trading Facilities ("OTFs") and topics that are connected specifically to the operational aspects of OTFs as described.

To put our response into context, WMBA member firms are global Wholesale Market Brokers providing, inter-alia, OTC intermediation services in the cash and derivative Rate, Credit, Foreign Exchange, Equity and Commodity marketplaces. Our members collectively have a physical presence in all major financial capitals globally as well as many secondary financial centres and provide intermediation services to, among others, customers in all 27 EU member states. Furthermore, WMBA members firms arrange the vast majority of OTC derivative transactions executed daily around the world.

WMBA member firms are limited activity firms that act as non risk-taking intermediaries with a principal client base made up of global banks, primary dealers, leading regional banks, government agencies, asset managers, oil companies and energy generators/utilities. Our primary function is to source, develop, manage and publicise liquidity pools for our customers to assist them in their global risk mitigation processes.

The WMBA and its member firms are in agreement with, and supportive of, the introduction of the OTF category under MiFIR as this proposed regime closely describes the current business model of WMBA members which has been successfully operational across global markets for over 50 years.

On that basis, contained within our response below you will find an elaboration of the following views and opinions:

- We agree that the introduction of OTFs will assist in accelerating the adoption of central clearing for OTC products and in publishing OTC transaction data to an array of regulators and supervisors, and that the discretion exercised by neutral market operators of OTFs is essential to preserve quality liquidity pools on the basis that OTFs maintain rigorous standards to ensure the integrity of the definition and the market as a whole
- We believe that the transparency waiver regime as proposed in MiFIR is also of vital importance for less liquid markets. If implemented correctly, the waiver regimes, whilst bringing enhanced transparency to markets, will ensure liquidity preservation

- It is essential, in order to safeguard competition across trading venues, that access to appointed CCPs is non-discriminatory in nature with an implementation process which is fair and transparent
- There is a material functional separation between OTFs for non-equities in MiFIR and equity OTFs in MiFID 2. Non-equity OTFs, especially those operating the matching of OTC derivatives, cannot convert to, nor operate as, MTFs

WMBA member firms look forward to being able to expand on these points during future conversations with the European Parliament. Further, in recent months other global regulators and policy makers have found it beneficial to participate in on-site visits to WMBA member firms in order to explore the range and methodology of our voice, hybrid and electronic brokerage services for global OTC cash and derivatives marketplaces. **We therefore extend an open invitation to all members of the ECON committee to visit any of our members' operations if that would be deemed helpful to your assessments.**

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1) Are the exemptions proposed in Directive Articles 2 and 3 appropriate? Are there ways in which more could be done to exempt corporate end users?

The WMBA is broadly in agreement with the level of exemption as proposed in Directives Articles 2 and 3. However, we believe, in general, that exemptions should be appropriately targeted and kept to a minimum to ensure that the goals of the G20 are met by maximising the number of OTC Derivatives transactions traded on organised venues and reported to prudential supervisors.

2) Is it appropriate to include emission allowances and structured deposits and have they been included in an appropriate way?

The WMBA is in favour of the proposed regulations encompassing the widest possible set of products so that standard conduct of business rules and systemic risk reduction techniques may be applied to as many markets as is practical. Therefore, we support the comprehensive inclusion of emissions and structured deposits within the proposed provisions.

4) Is it appropriate to regulate third party country access to EU markets and, if so, what principles should be followed and what precedents should inform the approach and why?

Reciprocal access both in and out of EU markets from third countries forms the basis for free trade and is therefore of vital importance to the resumption of growth across the world's economies. While the WMBA accordingly prefer an approach based on the principles of free trade, we recognise that, given the overriding need for market integrity and stability, some level of appropriate controls need to be in place.

However, the WMBA disagrees that "equivalence" between regimes should be a prerequisite for the provision of trade and investment. “Equivalence“ is the wrong approach because not only is anticipating the perfect alignment of each relevant third country's laws, regulations and supervision with that of the EU unrealistic, but also because implementation would be unwieldy to monitor in practice across borders.

The principle should be one of supervision and recognition rather than legal and governance regimes being symmetrical. Operations and operators do not need to function equivalently but rather to act as recognised firms in the eyes of their home supervisor therefore being able to conduct business fully compliant with their host regulators as being fit for purpose.

5) What changes, if any, are needed to the new requirements on corporate governance for investment firms and trading venues in Directive Articles 9 and 48 and for data service providers in Directive Article 65 to ensure that they are proportionate and effective, and why?

The WMBA is broadly supportive of the content and tone of the corporate governance requirements for trading venues outlined in Article 48. The WMBA is strongly in favour of highly rigorous standards for market operators to not only ensure compliance with the proposed rules but to promote universal confidence in the practices and procedures implemented for participants, regulatory bodies, supervisors and the general public.

6) Is the Organised Trading Facility category appropriately defined and differentiated from other trading venues and from systemic internalisers in the proposal? If not, what changes are needed and why?

The WMBA unequivocally endorses the introduction of OTFs as a recognised trading venue category on an equal footing with the existing categories in order to dramatically expand the number and type of OTC cash and derivative transactions that will be reported to national regulators and prudential supervisors. It is significant that the introduction of OTFs – as multi-lateral, acting with discretion with appropriate pre- and post-trade features and transaction reporting capability - effectively codifies the existing operational characteristics of OTC markets while at the same time correctly preserving the OTF category as a distinctly separate, but as a complimentary peer to RMs and MTFs. Capturing the widest possible range of OTC derivative trades, rather than imprudently attempting to reshape the products, is a logical first step in the transformation of the OTC marketplaces. Clearly, as the vast majority of OTC cash and derivatives do not trade continuously and are therefore unsuitable for execution purely on RMs and MTFs, it is unfeasible and inadvisable to attempt to remould the OTC marketplace into the currently recognised venue structures which are designed to cater for a different style of product and client base, and wholly different liquidity conditions. In addition to the introduction of OTFs as trading venues, the provision for OTF operator discretion in the choice of execution method (using a combination of voice, hybrid and electronic means) ensures that the maximum number of clearing eligible transactions may be sent to CCPs and reported to prudential authorities whilst, at the same time, ensuring that the highest quality and quantity of liquidity is harnessed and distributed to customers of these venues.

The highly electronic nature of many OTC marketplaces now operated by WMBA firms and running in parallel with hybrid marketplaces indicates that should the broad OTC cash and derivatives markets be sufficiently deep, continuous, uniform, and mature these products would already be executed electronically. That this has not been the case – despite huge infrastructure investments on the part of WMBA member firms – is testimony to support the existence of the OTF category as distinctly valuable. Indeed, the trading practices which will be initially captured under the OTF category acknowledge the nuances of the OTC markets by authorising operations under a hybrid model. For example, for products supported by both voice and electronic execution choices, on trading days where liquidity and number of participants is at a sufficiently continuous level, trading activity will migrate toward electronic execution, whilst on more volatile days where liquidity is scarce and less participants are present, trading activity will shift quickly toward voice based intermediation. It is the experience of WMBA member firms that in especially stressful market conditions the ratios of trades executed by voice versus those transacted electronically will fluctuate sharply on a temporary basis and therefore the OTF category promotes the capture of all transactions regardless of the changing conditions of the market over any hour or day. Therefore an additional positive feature of the OTF category, as it is proposed, is the assurance of continually capturing the maximum number of OTC trades for systemic risk management review by supporting the nuances of the existing OTC marketplace under all trading conditions. Indeed, the flexibility of the proposed OTF structure will guarantee that the percentage of OTC products made eligible for central clearing will be optimised as

we believe the voluntary submission for central clearing of non-mandated products will gather momentum within OTFs once clearing begins in earnest.

However, the WMBA also believes the current OTF definition is not sufficiently exacting regarding the conduct of business issues, product scope and class of participant.

Regarding conduct of business requirements, the WMBA believes that these terms should be more concisely prescribed with rigorous minimum standards demanded from a neutral OTF operator. We believe that, among other considerations, the operator must (a) be authorised and subject to regulation from its national authority; (b) be also recognised as an Organised Trading Venue by ESMA; (c) must have rigorous compliance oversight and governance procedures (as determined by MiFID and the rules of the relevant national regulatory authority/ESMA) which are clearly defined to all market participants; (d) maintain an adequate and independent compliance resource to enforce regulations and monitor codes of practice; (e) provide an impartial facility with access to multiple users and connections to all recognised central clearing and trade repository locations; (f) be supported by fully electronic post-trade services incorporating but not limited to affirmation and confirmation systems including where appropriate routing to third party clearing, settlement and exchange give-up mechanisms; (g) provide evidence it continuously conforms to all record keeping requirements accordant with authorisation; (h) have unambiguous rules designed to minimise, manage and/or disclose conflicts of interest; (i) exercise consistent standards and operate similar processes across all markets, clients and financial instruments; (j) provide market participants with access to (where possible) tradable prices on a non-discriminatory basis; (k) provide to all clients details of all tradable bids and offers as soon as reasonably possible and in a means and scope as may be advised by national regulator or host supervisor; (l) deny access for any participant unless it is reasonably satisfied, in accordance with marketplace rules and governance, that the client (via an agent or otherwise) is operationally capable of settling all transactions; (m) have in place MiFID/MiFIR compliant customer agreements, execution policies and customer categorisations; (n) be able to demonstrate the technological capacity to support, monitor and facilitate the smooth operation of front office procedures; (o) be financially robust as defined by the competent national regulator; (p) demonstrate dedicated business continuity arrangements as per the guidelines of ESMA and the relevant national regulator.

It should be stressed that since much of the cash markets in Europe for financial products (i.e. non derivatives) have long been and are currently executed via "Matched Principal" systems operated by WMBA member firms, in order to maintain market liquidity we believe the Level 1 text needs to give explicit reference for ESMA to permission and authorise wholesale OTF operators to continue to operate venues utilising the “IDB Matched Principal” mode of execution where WMBA members temporarily are the arranging agent buyer to the seller and the arranging agent seller to the buyer. For clarification, Matched Principal intermediation is not operating using one’s own capital but rather acting solely as arranger in these marketplaces. Therefore the Matched Principle model should be expressly authorised under the OTF regime. For the avoidance of doubt, WMBA members are currently able to conduct this business under our Limited Activity licences which expressly prohibit own account trading.

With respect to the scope of products available for trading on an OTF, the WMBA believe standards should contain the requirements that the product should: (a) be made available to be centrally cleared at multiple CCPs where possible; (b), be made available for bi-lateral execution where appropriate and reported to trade repositories for supervisory review; (c) be made available for electronic straight-through-processing; (d) have standardised identifiers; (e) be suitable for fully electronic confirmation and affirmation; (f) be suitable for processing by an approved trade repository; and (g) be able to be supported by compression, aggregation, and netting of trades for capital efficiency.

Finally, with respect to the class of participant trading on an OTF we would emphasise the requirement that in our view all participants should be regulated within the EU as either professional or eligible counterparties (regardless of per se or elective).

7) How should OTC trading be defined? Will the proposals, including the new OTF category, lead to the channelling of trades which are currently OTC onto organised venues and, if so, which type of venue?

We concur with the Commission that in scoping out the OTF category as widely as demonstrated in the proposals, it is highly likely that much of the business between professional and eligible counterparties which may be currently described as OTC will occur within the bounds of an organised trading venue, specifically, on an OTF.

Further, it is likely that the availability of CCP clearing to a wider variety of products traded on an OTF will increase inexorably once clearing is formally activated. The WMBA believe that given the lower capital costs applied to cleared trades and the growing appetite for central clearing as a consequence of lower counterparty credit ratings it is logical to assume a steady migration of non-equity OTC products onto the OTF venues.

Since current OTC trading is predominantly handled by WMBA member firms and, since these firms will become OTFs, it is additionally logical to presume that most products previously considered OTC will naturally be executed by the major OTF venues.

Clearing and reporting will transform the fabric and behaviour of the OTC market – as is intended by the legislation. The WMBA is aware that the Commission will shortly provide proposal for CSD regulation. In light of the importance of such services that will include initiatives from the Eurosystem (T2S and CCBM2) we recommend legislators to keep in mind this forthcoming legislation to potentially impact RM, MTF and OTF markets. Hence MiFID2/MIFIR should not aim to legislate the clearing and settlement area, while reporting has already been covered within EMIR.

10) How appropriate are the requirements for investment firms to keep records of all trades on own account as well as for execution of client orders, and why?

We would point out again that WMBA member firms do not take positions or assume market risk, and that Limited Licence and Limited Activity authorised firms cannot facilitate execution of client orders against the proprietary capital of the investment firm or market operator.

Further, as intermediaries authorised and regulated by their national competent authority (predominantly the FSA currently), WMBA member firms have been required by law to keep records for at least 7 years for well over two decades, and as a practical matter maintain most electronic records indefinitely.

11) What is your view of the requirement in Title V of the Regulation for specified derivatives to be traded on organised venues and are there any adjustments needed to make the requirement practical to apply?

The WMBA agrees with the premise of Title V and notes the high degree of importance that is placed by EMIR upon ESMA to define and specify those classes of derivative subject to the trading obligation. Clearly, the nuances involved in “assessing liquidity”, which as outlined in Question 6 does vary greatly from time to time (especially in OTC derivatives which do not trade continuously), reinforces the critical need for the OTF category to remain in place so that products may be available to trade and available to be cleared regardless of execution method in every conceivable market environment.

With regard to third country trading venues, the WMBA is concerned that there could be a regulatory gap with overseas venues or intermediaries who are not regulated to the same properly high standard as demanded in MiFIR entering the EU due to equivalence access being too lax. We would therefore question whether such overseas entities should first be required to establish a branch in the EU and be regulated as such via passport issued internally.

With regard to third country CCPs, we disagree with the term "provided that the third country provides an equivalent reciprocal recognition of trading venues" for the reasons stated in Question 4. The mutual recognition and authorisation of a "Home and Host" passporting regime is a far better technique to facilitate the transactions of global counterparties engaging in world trade, rather than in seeking to enforce EU law into third country regimes.

Lastly, we would echo our comments from Question 1 to reiterate that waivers for non-financial counterparties and uncleared trades should be kept to a minimum so that the uniform implementation of the proposed rules applies to as many markets and many market participants as possible to support the G20 objective of effective systemic risk management tools being given to supervisors.

13) Are the provisions on non-discriminatory access to market infrastructure and to benchmarks in Title VI sufficient to provide for effective competition between providers? If not, what else is needed and why? Do the proposals fit appropriately with EMIR?

As venues for derivative trading, the OTF requires and relies upon the certainty of non-discriminatory access to clearing. The WMBA fully supports and welcomes the enhanced requirements that MiFIR details over and above those within EMIR.

The WMBA understands the need for prudential management by CCPs but fundamentally disagrees with the premise that a vertically integrated CCP operating as a privately held entity in a "for profit" capacity should be able to act as discretionary gatekeeper to third party trading venues.

Instead, the authorisation of a venue as an OTF under MiFIR should incorporate the authorisation of that venue to freely and fairly submit venue executed transactions to any authorised CCP of the counterparties' choice using the European passport provisions as entry to such facilities.

Additionally, through the experience of managing our trading systems, WMBA members recognise that barriers to entry to the submission of trades to a CCP may not only be via acceptance of the actual trade but also via many other factors including but not limited to: (a) the cost of clearing offered to a particular participant; (b) the speed of response to inquiries relating to technical matters including infrastructure, messaging, connectivity, and access to APIs; (c) the hidden bundling of costs within the vertical CCP silo; (d) the slower acceptance for clearing of trades executed at third party venues than those executed at the vertical silo venue; (e) varying speeds of affirmation and novation messaging by participant type; and (f) curtailed access to third party venues of the credit and collateral status of clearing members.

Rather than being subject to the potentially capricious use of the three month review and response periods the WMBA would therefore recommend that the clearing eligibility of a product should not come into force under ESMA until a sufficient number of recognised applicant OTFs have been granted equal satisfactory access into the requested CCPs, and that the period of the consideration of which products should be centrally cleared should run concurrently with the review of the OTF access applications.

18) Are the protections available to eligible counterparties, professional clients and retail clients appropriately differentiated?

The protections available to each category of market participant are appropriately differentiated. However, the application of the protections to each type of trading venue needs to be proportionate and relevant to the trading venue's range of market participant.

We note that non-equity OTFs operated by WMBA member firms would almost entirely be available only to the MiFID classifications of "Eligible Counterparties" and "Professional Clients". Therefore the retail protections that need to be accommodated in non-equity OTFs should be proportional to the make-up of the client base. That is, in the case of existing WMBA member firm business models, non-equity OTFs would be absent of retail participation.

It is safe to say that due to the complexity of product structure and the large average nominal size of the wholesale OTC cash and derivative markets it would be unusual for a retail investor to transform into a professional client or eligible counterparty. Therefore as we feel it is highly unlikely that retail clients would need to be re-classified there is no need to allow for this event.

19) Are any adjustments needed to the powers in the Regulation on product intervention to ensure appropriate protection of investors and market integrity without unduly damaging financial markets?

Given the globally integrated nature of the wholesale markets our members operate, we would emphasise the value in having the different categories of client classifications. As such, product intervention to ensure appropriate protection of investors should apply to the distribution of financial products to retail counterparties only. At a professional and especially at an eligible counterparty level, such intervention would be ineffectual and counterproductive as (a) these entities are competent and informed professionals by virtue of their authorisations; (b) the responsibility and onus of suitability is implicitly shifted from the authorised counterparty to the competent authority; and (c) trade execution from these entities may simply migrate outside EU jurisdiction.

Further, product intervention powers should be exercisable only on proof of damage, not risk of damage. Product intervention powers should also be stated to be exercisable only where there is a significant and tangible threat to investor protection or the viability of the market.

21) Are any changes needed to the pre-trade transparency requirements in Regulation Articles 7, 8, 17 for all organised trading venues for bonds, structured products, emission allowances and derivatives to ensure they are appropriate to the different instruments? Which instruments are the highest priority for the introduction of pre-trade transparency requirements and why?

As described in our answers to questions 6 and 7 above, WMBA member firms already deliver OTC pre-trade transparency for price discovery via the blending of expert voice-broker knowledge; broadcasting via extensive local, regional and global communication networks; sophisticated electronic trading venues; and electronic distribution models either via their own proprietary data businesses or in partnership with data vendors such as Thomson Reuters and Bloomberg among others. The fierce competition between intermediaries such as the members of the WMBA to provide market information transparency to their clients, combined with the dealers also striving to execute at the best price are both dependent upon the widespread dissemination of prices and interests by venues. Such “shopping around” as is conventional market practice by clients and participants has served to generate a substantial and sufficient degree of pre trade transparency prior to execution in markets transacted using voice and hybrid methods.

Given the vast number of current and possible OTC derivative instruments (for example there are 110 million possible start and end date combinations for interest rate swaps maturing between 1 day and 50 years that might be made available for clearing at a CCP), the potential complexity of OTC derivative instruments which might contain multiple parts or "legs", the periodic nature of many OTC products (which may trade infrequently even in very large nominal amounts) – it is clear that a variety of acceptable transparency methods should be considered. Further, many pre-trade prices are merely "indications of interest" which may or may not have bearing on the transactions eventually executed. Many OTC cash and derivative prices are subject to the availability of correlated 'hedges' and are fleeting. And many trades involve multiple buyers and/or multiple sellers "joining" a trade as it is being executed and this "work-up" process means on many occasions there is little correlation between pre-trade and post-trade reporting on a given transaction. Therefore we believe the potential pre-trade regime should be carefully targeted towards the needs of end users so that pre-trade price discovery may continue unimpeded amongst the hundreds of OTC cash and derivatives participant entities.

Whereas the principles and objectives of pre-trade transparency as set out are understood and supported by the WMBA, the vast amount of distinct and individual cash and derivative product types, combined with their constant rollover or resetting, means that the pre-trade waivers described in Article 8 (sub-point 4) should be very broadly applied in order to maintain liquidity in these markets, especially in light of the fact that the fundamental purpose of the G20 objectives – heightened and immediate systemic risk management – is entirely dependent on analysing post-trade, not pre-trade, events.

Moreover, it has been highlighted in a number of independently issued central bank studies that the real world impact of forcibly generated pre-trade transparency remains uncertain, and after much discussion it remains unproven without doubt that liquidity provision will not be dramatically reduced where overly prescriptive pre-trade transparency is applied. The WMBA believes that a non-calibrated pre-trade transparency regime must be unambiguously proven to not compromise liquidity provision, rather than being introduced on a speculative basis that the effect will be net positive.

Therefore whilst the initial application of common pre-trade standards for each sub-category of Organised Traded Venues (allowing for subsequent proportional and periodic waivers to be applied by ESMA) may seem the fairest way to ensure consistency of standards, this may prove too difficult to consistently apply in practice and should be avoided.

Additionally, the concept of imposing a regime for pre-trade transparency requirements only to remove the large bulk of these at the second step would appear to the WMBA to be onerous on market operators, counterparties and especially ESMA. Such a basic inefficiency may struggle to pass a cost benefit analysis, with the resulting consequences of higher end user costs and an incentive for market users to migrate business away from the EU jurisdiction.

22) Are the pre-trade transparency requirements in Regulation Articles 7, 8 and 17 for trading venues for bonds, structured products, emission allowances and derivatives appropriate? How can there be appropriate calibration for each instrument? Will these proposals ensure the correct level of transparency?

As outlined in Question 21, the large diversity of product within the prospective OTF framework, combined with the continuously changing liquidity environment with respect to the trading of these products, means that any fixed regime will be inappropriate. Therefore the WMBA would strongly encourage the broad allowance for well-considered calibration via the close supervision of existing pre-trade standards and conduct in accordance with the Level 2 implementation by ESMA.

23) Are the envisaged waivers from pre-trade transparency requirements for trading venues appropriate and why?

We again emphasise that the mandating of an overly prescriptive and inappropriate pre-trade transparency regimen in non-equity products would only serve to reduce the ability and motivation of market participants to allocate their capital for price formation. This would reduce liquidity, increase market inefficiencies and further load costs and therefore risks onto the balance sheets of end users.

The WMBA understands the necessity for a waiver regime as described in the proposals. This is particularly the case should the pre-existing pre-trade framework from regulated and equity focused venues with large scale retail participation and direct market access be imported, dangerously in our opinion, into non-equity OTFs which operate with none of these models.

However, as described above, we would consider this option to be inefficient and costly to end users. Instead, the WMBA would advocate focusing on post-trade transparency and reporting to highlight where systemic risk may be developing. This is, after all, why the pending legislation has been created.

25) What changes if any are needed to the post-trade transparency requirements by trading venues and investment firms to ensure that market participants can access timely, reliable information at reasonable cost, and those competent authorities receive the right data?

The WMBA completely supports a wide scale post-trade transparency regime for OTFs in the understanding that it is respectful of the indispensible factor of liquidity provision (i.e. market-making), with modest reporting modifications and calibrations based on transaction size.

As outlined in Question 21, many OTC cash and derivative products trade infrequently but in very large nominal amounts – exponentially larger than in equities – and accordingly appropriate reporting adjustments for different size trades and different assets classes are necessary to ensure that the impact is not such so as to disincentivise the liquidity provision that is essential to facilitating risk transfer for end-users.

Ideally, post-trade exposure will be calibrated to allow market participants access to a similar level of liquidity to that which they have provided to their end user clients in a particular asset class. Over time, if liquidity providers are continuously penalised through liquidity being withdrawn by other market participants who have been informed prematurely of a given transaction – especially in products that trade infrequently and therefore carry a wide buy price to sell price spread - the quality of price shown to end users will decline substantially.

It is important to distinguish between (a) regulatory and supervisory bodies who are entitled to receive granular, immediate settlement-level information regarding the full economic terms of transactions and the identity of counterparties either directly from venues or via utilities or trade repositories under the transaction reporting rules; (b) market participants who need timely and accurate information they can act on in confidence; and (c) the general public who have an interest in aggregated, end of day data for the marking and review of investments.

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