making sense of MiFID II

PMQs

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Developments in Market Structures under MiFID II

The review of MiFID gathered considerable pace during 2010 and the year ended with the publication of the EC's Public Consultation paper on the Review of MiFID. This paper focuses on the revision of the framework Directive of MiFID, setting a deadline of 2nd February 2011 for public consultation.

So, what can we expect from the updated Directive (MiFID II)?

Well, one of its primary aims is to provide more appropriate regulatory coverage for the multitude of different trading facilities and methods of execution that have emerged over the last 3 years. Currently, under MiFID, trading venues or platforms are classed as Regulated Markets (RMs), Multilateral Trading Facilities (MTFs) or Systematic Internalisers (SIs). A new broad definition is likely to be introduced to apply regulation to all organised trading outside of the current set of venue types – Organised Trading Facilities (OTFs). Broker dark pools and crossing systems would fall into this category, and it's not just for equities.

What kind of regulatory control will OTFs be subject to?

OTFs would be subject to requirements for monitoring all trading with a view to identifying market abuse. They would be required to use a unique code identifying the system for trade and transaction reports. There's also mention of the possibility that OTFs may be required to convert to MTF status once they reach an asset-specific threshold.

Is this a good thing?

Well, as MTFs, they would be subject to regulation in a way that OTFs are not so some brokers may be inclined to avoid this level of scrutiny. OTF operators may, for example, cap trading volumes on such systems in order to remain below the threshold set by the regulators.

OTF operators may also be required to publish aggregated information at the end of each day including the number, value and volume of all transactions executed using the system.

Will these changes apply only to equity markets?

No, there is likely to be a move towards trading standardised OTC derivatives **on** exchange, adopting the RM, MTF and OTF structure.

And what about HFT and Algo trading?

It is expected that Automated Trading will be added as a broad definition to the framework Directive, bringing High Frequency Trading (HFT) and algorithmic trading firmly onto the regulatory radar.

Regulation could then be introduced in this area around risk controls to guard against system error and market abuse. Potentially, HFT market operators would be required to provide liquidity on an ongoing basis (similar to market makers) or to ensure that their orders rest on the order book for a specified minimum time.

We can also expect to see clarification of the criteria used to determine when a firm qualifies as a Systematic Internaliser (SI). With this clarification we could see the emergence of more SIs.

Overall, there is a move toward establishing a more level playing-field in terms of the way in which RMs and MTFs are regulated. The thinking is that, where organisations operate similar businesses of similar sizes, they should be subject to the same regulation. There is also a focus on improving market surveillance, with the EC calling for more co-operation between RMs, MTFs and OTFs trading the same instruments. If this 'co-operation' becomes electronic, there could be further opportunities for standardisation.

The EC also proposes to promote small and mid-cap markets (Small and Medium sized Enterprises, or SMEs) by adding a new definition of 'SME Market' with appropriate, proportionate regulation, including pre- and post-trade transparency requirements.

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