MiFID 2: Market structure

Summary

The revised Markets in Financial Instruments Directive (MiFID 2) and the new Markets in Financial Instruments Regulation (MiFIR) were approved by the European Parliament and European Commission in April/May 2014 and published in the Official Journal of the European Union in June 2014. Following several rounds of consultation, Level 2 legislation supporting MiFID 2 and MiFIR has been (or is in the process of being) adopted by the Commission and is due to be published in the Official Journal of the European Union following a period of scrutiny by the European Parliament and Council.

This briefing provides a refresher on the principal changes introduced in MiFID 2 and MiFIR in relation to market structure and focuses in addition on some of the key issues coming out of the relevant Level 2 legislation in the form of regulatory technical standards (RTS) and Delegated Acts.

The texts of MiFID 2 and MiFIR are of EEA relevance and hence will be applicable to non-EU, EEA countries once incorporated into the EEA Agreement. Whether MiFID 2 and MiFIR will continue to apply in the UK, if the UK were to invoke Article 50 of the Lisbon Treaty, and consequently leave the EU (Brexit), depends upon the future relationship of the UK and the EU. If the UK were to remain a member of the EEA following a Brexit, they would continue to apply once incorporated into the EEA Agreement; but in other scenarios, the UK would become a third country for the purposes of MiFID 2 and MiFIR, unless special terms were negotiated between the UK and EU.

If the UK becomes a third country for the purposes of MiFID 2 and MiFIR, it is likely to seek to utilise to the maximum the equivalence recognition provisions, where available. The FCA has confirmed that firms should proceed with the implementation of MiFID 2 and MiFIR, which would enable the UK to demonstrate equivalence if necessary.

Following political agreement, the transposition and application date of MiFID 2 and MiFIR have been delayed to 3 July 2017 and 3 January 2018, respectively.

Key business impacts

- Investment firms operating internal crossing systems will have to decide whether these systems can become, or will be, organised trading facilities (OTFs) or multilateral trading facilities (MTFs).
- Investment firms will need to determine whether they are acting as systematic internalisers (SIs) in a wide range of equity, fixed income and derivative financial instruments. This will be a particular issue for the fixed income and over-the-counter (OTC) derivatives markets, which operate currently as dealer markets

with firms trading on a bilateral basis as principals.

- Central counterparties (CCPs) and market operators will have to look at the opportunities and challenges presented by the promotion of non-discriminatory access to clearing services, trading venues and benchmarks.

Introduction

The market structure changes include significant and contentious proposals for market participants.

- The creation of a new category of trading venue - the OTF.
- Measures to push more trading onto regulated trading venues - regulated markets (RMs), MTFs and OTFs - and SIs.
- Measures to promote access to clearing facilities and benchmarks to improve competition between CCPs and trading venues.
- A requirement that all trading in equities be done on a regulated trading venue (i.e. an RM or MTF) or with an SI.
- Provision for certain derivatives that are subject to the mandatory clearing obligation under the European Markets Infrastructure Regulation (EMIR) to be required to be traded on trading venues (RMs, MTFs and OTFs).
- Requirements imposed on investment firms and trading venues in relation to algorithmic and high frequency trading.

Level 2 measures on market structure are set out in:

- RTS 1 (C(2016) 4390): RTS on transparency requirements for trading venues and investment firms in respect of shares, depositary receipts, exchange-traded funds, certificates and other similar financial instruments;
- RTS 4 (C(2016) 2710): RTS on criteria for determining whether derivatives subject to the clearing obligation should be subject to the trading obligation;
- RTS 5 (C(2016) 3544): RTS on direct, substantial and foreseeable effect of derivative contracts within the Union;
- RTS 6 (C (2016) 4478): RTS specifying the organisation requirements of investment firms engaged in algorithmic trading;
- RTS 7 (C (2016) 4387): RTS specifying organisational requirements of facilities trading venues allowances and derivatives;
- RTS 8 (C (2016) 3523): RTS specifying the requirements on market making agreements and schemes;
- RTS 11 (C (2016) 4389): RTS on tick size regime for shares, depositary receipts and exchange-traded funds;
- RTS 15 (C (2016) 3807): RTS on clearing access in respect of trading venues and central counterparties;
- RTS 16 (C (2016) 3203): RTS on access in respect of benchmarks; and
- Commission Delegated Regulation (C (2016) 2398) of 25 April 2016 (the Delegated Act).

The OTF concept is intended to fill a perceived gap in the spectrum of multilateral trading venues covered by MiFID and address concerns about the effects of such systems on transparency and price formation processes

Trading venues

MiFID 2 retains the MiFID concepts of RMs, MTFs and SIs, but it introduces a new category of multilateral trading venue, the OTF. The scope of the SI activity is also broadened.

OTFs

An OTF is defined as a multilateral system, which is not an RM or MTF, in which multiple third-party buying and selling interests in bonds, structured finance products, emissions allowances or derivatives (non-equity instruments) are able to interact in the system in a way that results in a contract. The OTF concept is intended to fill a perceived gap in the spectrum of multilateral trading venues covered by MiFID and address concerns about the effects of such systems on transparency and price formation processes.

The OTF category is limited in scope to non-equity instruments. Since derivatives are permitted to be traded on an OTF it will be possible to trade equity derivatives on an OTF, but not the underlying cash equity instrument.

One controversial area has been the prohibition on investment firms and market operators operating an OTF from executing orders in the OTF against their own proprietary capital, or from any entity which is part of the same corporate group or legal person as the investment firm or market operator executing orders against their own proprietary capital in the OTF. The preference of European authorities is to keep the operator in a neutral role. This prohibition does not sit easily with the functionality of a number of firms' systems which are used to execute both client trades and the firm's own trades (e.g. trades hedging the firm's exposure under derivatives).

Following a debate through the legislative process as to whether 'matched principal' trading should be treated as trading against proprietary capital for these purposes, the text prohibits matched principal trading by the operator of the OTF with the exception of matched principal trading in respect of non-equity instruments (other than derivatives that have been declared subject to mandatory clearing) and only in cases where the client has been informed of the process. For these purposes there is a narrow definition of matched principal trading. In particular, the definition requires the 'facilitator' of the trade (i.e. the investment firm or market operator) to execute both sides of the trade 'simultaneously' and 'at a price where the facilitator makes no profit or loss, other than a previously disclosed commission, fee or charge for the transaction'.

As an exception to the general prohibition on trading against proprietary capital, Member States may permit OTFs to deal on own account in sovereign debt instruments for which there is not a liquid market; this exception is in recognition of the fact that investment firms can provide important liquidity in illiquid European sovereign debt.

As a further restriction on OTFs, the text prohibits the operation of an OTF and an SI from taking place within the same legal entity. This is likely to be problematic for large broker-dealers whose trading operations comprise a wide variety of execution methods across different financial instruments, and typically through the same legal vehicle. Furthermore, orders in an OTF are not permitted to interact with quotes in an SI, nor are OTFs permitted to connect with each other so that orders in different OTFs can interact. This will limit the extent to which orders can be routed between OTFs or between OTFs and SIs, and would appear to cut across the best execution obligations of an investment firm that is also an SI, where the best result for the client would be to route the order to an OTF (and similarly where an investment firm is operating an OTF and the best result for the client would be to route the order to an SI). There is no equivalent restriction on an OTF connecting to an RM or MTF.

OTFs are required to exercise discretion when executing orders (and this is one of the features distinguishing OTFs from RMs and MTFs). However, the scope of the permitted discretion is limited to two circumstances: discretion regarding whether to place an order within the OTF or to retract it; and discretion regarding whether to match specific client orders with other orders in the system (or, for crossing systems, to decide how much of a client order to match with other orders).

Importantly, investment firms and market operators operating an OTF are subject to investor protection obligations, such as best execution, when executing client orders in the OTF. This is a potentially significant extension for market operators should they choose to operate an OTF as they have not been subject to such obligations to date.

Given the limitations placed on the OTF category it is questionable how attractive this option will be to investment firms and market operators in practice.

Multilateral systems for equities

Firms operating internal crossing systems for equities will have to make a decision on the future of their internal crossing systems

Firms operating internal crossing systems for equities will have to make a decision on the future of their internal crossing systems, as MiFIR will require all internal matching systems that execute client orders in shares, depositary receipts, exchange-traded funds (ETFs), certificates and other similar financial instruments on a multilateral basis to be registered as MTFs.

SIs

Following implementation of MiFID, a smaller number of firms became SIs than the European authorities had expected. The qualitative nature of the criteria that defined an SI made the assessment highly subjective and many firms concluded that they did not meet the criteria. MiFIR will introduce quantitative criteria to supplement the qualitative ones to try to make the definition more objective.

The SI definition in MiFID 2 is not, on its face, significantly different to the current definition in MiFID. It applies to an investment firm which, on an organised, frequent and substantial basis, deals on own account by executing client orders outside a RM, MTF or OTF. However, MiFID 2 sets out two quantitative thresholds:

(i) the 'frequent and systematic' basis will be measured by the number of OTC trades in the financial instrument carried out by the investment firm on own account by executing client orders; and

The result of these changes is that more firms are expected to be treated as SIs, and for a much wider range of financial instruments, under MiFID 2

(ii) the 'substantial' basis will be measured either by the size of the firm's OTC trading in relation to the total trading of the firm in a specific financial instrument or by the size of the firm's OTC trading compared with the total trading in the EU in a specific financial instrument.

Both thresholds must be crossed in order for an investment firm to be defined as an SI (although firms are also able to opt into the regime).

The Delegated Act provides specific thresholds for the meaning of "frequent and systematic" and "substantial" for each of the following types of instruments:

- shares, depository receipts, ETFs, certificates and other similar financial instruments;
- bonds;
- structured finance products;
- derivatives; and
- emission allowances.

A number of uncertainties remain regarding how the SI calculations should be performed and which transactions should be taken into account. It is hoped that further clarification and guidance will be provided by ESMA in due course.

Under the current MiFID regime, the SI role applies only in respect of dealing in shares that are admitted to trading on an RM. Consistent with the general extension of the pre-trade transparency regime, under MiFID 2 the SI role will be expanded to cover various equity-like instruments including depositary receipts, ETFs, certificates and other 'similar financial instruments' (equity instruments) where client orders are executed outside a trading venue. Importantly, the SI category will also be extended to cover non-equity instruments. This will be a significant change to a market that has been predominantly to date a dealer market, with investment firms trading as principal on a bilateral basis and not subject to any formal pre-trade transparency.

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Trading and clearing requirements

MiFIR introduces a number of measures that are designed to push more trading onto one of the categories of regulated trading venues and SIs.

Trading obligation – shares

In order to ensure that shares are traded on venues that are subject to transparency requirements, under MiFIR investment firms will need to ensure that trades in shares admitted to trading on an RM or traded on an MTF only take place on an RM, MTF, SI or equivalent non-EU trading venue. A firm will be able to execute a trade elsewhere only if the trade is non-systematic, ad hoc, irregular and infrequent, or if it is carried out between eligible and/or professional counterparties and does not contribute to the price discovery process. The trading obligation is therefore likely severely to curtail the ability of investment firms to trade shares OTC unless they are doing so as an SI.

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The characteristics of non-systematic, ad hoc, irregular and infrequent are not subject to any further specific guidance. ESMA does not have a mandate to provide RTS on these characteristics, but indicated during its consultation process that it may provide further guidance through guidelines. ESMA's stated preference is for non-systematic and infrequent to be interpreted consistently with the concepts of systematic and frequent for the SI definition.

RTS 1 provide an exhaustive list of the types of transactions in shares which do not contribute to the price discovery process including, for example, give-up or give-in trades and securities financing transactions.

Trading obligation – derivatives

A similar push onto trading venues will apply to standardised OTC derivatives in order to implement the G20 commitment to move all trading in such derivatives to organised venues where appropriate.

MiFIR contains a procedure for ESMA to designate derivatives that are subject to the mandatory clearing obligation under EMIR, and which are sufficiently liquid, to be traded exclusively on EU regulated trading venues or non-EU trading venues deemed 'equivalent' by the Commission. In addition, ESMA may suggest that other classes of derivatives should be subject to the obligation under a separate process. Whether or not a class of derivatives subject to the clearing obligation should also be made subject to the trading obligation will be determined by two main factors, a venue test and a liquidity test.

RTS 4 set out the criteria that ESMA should follow when determining whether derivatives are considered sufficiently liquid to trade exclusively on trading venues and should therefore be subject to the trading obligation.

In addition, ESMA is consulting on stakeholders' views on ESMA's first proposals on how to implement the trading obligation for derivatives and on ESMA's preliminary analysis of some classes of derivatives that could become subject to the trading obligation. Comments on the consultation are due by 21 November 2016 Following the consultation, ESMA may propose detailed rules to the Commission specifying the classes of derivatives subject to the obligation; the date or dates from which the obligation takes effect; any applicable phase-ins; and the categories of counterparties to which the obligation applies. ESMA estimates that it would propose these detailed rules, if deemed appropriate, in Summer 2017.

ESMA is required to publish and maintain a register on its website specifying the derivatives that are subject to the trading obligation, the venues where they can be traded and the dates from which the obligation takes effect.

The obligation to trade a derivative contract on a RM, MTF, OTF or equivalent non-EU trading venue will apply to trades between financial counterparties and non-financial counterparties above the clearing threshold (as defined in EMIR) as well as between such financial and non-financial counterparties and third country (i.e. non-EU) financial institutions and entities. The trading obligation will apply to contracts between certain third-country entities where the contract has a direct, substantial and foreseeable effect within the EU or where it is necessary or appropriate to prevent evasion of MiFIR. What this means is further specified in RTS 5, with the approach taken being consistent with that under EMIR.

As has been the case in relation to the extra-territorial effect of the obligations in EMIR, the extra-territorial effect of the trading obligation has the potential to create difficulties for firms where trades are subject to overlapping EU and non-EU regulatory regimes.

Limited exemptions from the trading obligation are available for certain intra-group transactions, transactions entered into for the purposes of termination or replacement of derivative contracts in a portfolio compression exercise and transactions with certain pension schemes in reliance on EMIR transitional provisions.

Algorithmic trading, market making and direct electronic access

Algorithmic trading

MiFID 2 includes specific requirements for investment firms engaging in ‘algorithmic trading’

HFT and algorithmic trading have attracted significant attention over recent years. MiFID 2 includes specific requirements for investment firms engaging in ‘algorithmic trading’. This is defined relatively widely and will catch any trading where a computer algorithm automatically determines individual parameters of orders (e.g. whether to initiate the order, timing, price or quantity of the order) with no, or limited, human intervention. The definition excludes systems that are only used to route orders to trading venues, to process orders where there is no determination of the trading parameters, to confirm orders or for the post-trade processing of executed transactions. Nevertheless the definition will catch a significant number of electronic systems.

Specific provisions apply to firms carrying out a ‘high frequency algorithmic trading technique’, defined as any algorithmic trading technique characterised by the use of infrastructure designed to reduce latency, absence of human intervention for initiating, generating, routing or executing orders and high message rates.

The Delegated Act specifies further key elements of the definitions for ‘algorithmic trading’ and ‘high frequency algorithmic trading technique’. For the purposes of the definition of ‘algorithmic trading’, it is clarified that a system shall be considered as having no or limited human intervention where, for any order or quote generation process or any process to optimise order-execution, an automated system makes decisions at any of the stages of initiating, generating, routing or executing orders or quotes according to pre-determined parameters.

For the purposes of the definition of ‘high frequency algorithmic trading’, a high message intraday rate shall consist of the submission on average of either (i) at least 2 messages per second with respect to any single financial instrument traded on a trading venue, or (ii) at least 4 messages per second with respect to all financial instruments traded on a trading venue.

Firms using algorithmic trading must have systems and risk controls to ensure that their trading systems are resilient, have sufficient capacity and are subject to appropriate thresholds and limits to prevent erroneous orders or other problems that may create a disorderly market, as well as ensuring that their systems are not used to commit market abuse.

Such requirements arguably already exist without the need for specific provisions to this effect. However, RTS 6 set out the detailed systems and controls requirements that investment firms must put in place for their algorithmic trading. These cover:

- the governance arrangements which an investment firm must have in order to establish and monitor its trading systems and trading algorithms, including where it outsources or procures software or hardware used in algorithmic trading activities;

- the role of the compliance function and the level of understanding which the compliance function must have of the firm's algorithmic trading systems;
- the staffing needed to manage the firm's algorithmic trading and the skills such staff should have;
- the requirements for testing new and updated algorithmic trading systems, trading algorithms or algorithmic trading strategies;
- the annual self-assessment and validation of the firm's algorithmic trading systems, including stress testing of those systems;
- the requirement that the investment firm must know which algorithm, trader, trading desk or client is responsible for each order sent to a trading venue and the need to be able to cancel orders;
- the requirement to have automated surveillance systems to monitor for market abuse, as well as the requirement to undertake real time monitoring of all algorithmic trading activity for signs of disorderly trading;
- the establishment of pre-and post-trade controls, such as limits on the value or volume of orders to prevent 'fat finger' errors; and
- security arrangements applicable to the firm's algorithmic trading systems.

MiFID 2 will require investment firms to notify their home regulator, as well as the regulators of the trading venues they trade on, if they are using algorithmic trading strategies. The firm's home state competent authority is entitled to ask for further information regarding the strategies, trading parameters and limits, as well as the key compliance and risk controls the firm has in place.

The final rules stop short of earlier suggestions that firms would need to disclose their actual algorithms routinely to regulators

The competent authority of a trading venue on which an investment firm is pursuing an algorithmic trading strategy may ask the firm's home state competent authority to provide it with the information it receives from the firm. However, the final rules stop short of earlier suggestions that firms would need to disclose their actual algorithms routinely to regulators.

Market making

Firms that use algorithmic trading to pursue a 'market making strategy' (effectively posting firm, simultaneous two-way quotes on trading venues) will be subject to specific obligations to carry out their market making activity continuously during a specified proportion of a trading venue's trading hours in order to provide liquidity on a 'regular and predictable basis to the trading venue'. They will have to enter into a binding written agreement with the trading venue which specifies what the firm's obligations are to carry out market making activity (e.g. what the firm's quoting obligations are in relation to particular financial instruments), as well as ensuring they have systems and controls to ensure they can fulfil their obligations under the market making agreement at all times. In effect, such firms will be subject to explicit market making obligations imposed by MiFID 2 whether or not they are formal market makers. These provisions are intended to address the perceived issue of liquidity provided by electronic trading disappearing from the market at critical points.

RTS 8 set out that an investment firm will be considered to be pursuing a market making strategy requiring the firm to enter into a formal market making agreement with the trading venue where the firm posts firm, simultaneous two-way quotes of comparable size and competitive prices when dealing on own account in at least one financial instrument for at least 50 per cent of the daily trading hours of continuous trading on the particular trading venue for at least half the trading days over a one month period.

The RTS further specify that:

- firm quotes include any order or quote that can be matched under the rules of the trading venue;

- quotes are simultaneous two-way quotes if they are posted so that both sides are present on the order book at the same time;
- quotes are of comparable size when their prices do not diverge by more than 50 per cent from each other; and
- quotes will be competitive if they are within the maximum bid-ask range set by the trading venue and imposed on firms that have signed up to market making agreements.

The RTS also specify the minimum content requirements for market making agreements and the exceptional circumstances that mean investment firms are not required to provide liquidity.

Direct electronic access

MiFID 2 imposes obligations on firms offering clients direct electronic access (DEA) (which includes direct market access and sponsored access) to trading venues to have systems and controls to ensure the suitability of clients using the service, to ensure that such trading does not exceed appropriate pre-set trading and credit thresholds and is monitored so as not to create, or contribute to, a disorderly market or constitute market abuse.

The Delegated Act specifies further key elements of the definition of DEA, including that a person shall not be considered to have DEA where, either:

- that person cannot exercise discretion regarding the exact fraction of a second of order entry and the lifetime of the order within that timeframe; or
- order transmission takes place through arrangements for optimisation of order execution processes that determine the parameters of the order other than the venue or venues where the order should be submitted, unless these arrangements are embedded into the clients' systems and not into those of the member or participant of a regulated market or of an MTF or a client of an OTF.

Responsibility is imposed on investment firms offering DEA to ensure that their clients using the service comply

Responsibility is imposed on investment firms offering DEA to ensure that their clients using the service comply with the requirements of MiFID 2 and the rules of any trading venue they are trading on.

Pursuant to RTS 6, investment firms offering DEA will have to apply the pre- and post-trade controls, surveillance for market abuse and real time monitoring to their DEA clients' trading as well as to their own. The RTS set out a number of specific additional requirements that DEA providers' systems must meet, including the ability to block or cancel orders from DEA clients in particular circumstances. DEA providers must conduct due diligence on prospective DEA clients to ensure they meet the standards set out in the RTS and any trading venue they intend to trade on. Even once the client has been accepted as a DEA client, the DEA provider must conduct an annual risk-based reassessment of a client's systems and controls.

Firms will have to notify their home state competent authority, as well as that of any trading venue to which they provide DEA, that they are offering DEA. The home state competent authority can require the investment firm to provide it with information on the systems and controls the firm has in place to monitor and control its DEA. The home state competent authority will provide this information to the competent authority of the trading venue if requested.

Trading venues' systems, circuit breakers, electronic trading, market making and tick size regimes

Systems, circuit breakers and electronic trading

MiFID 2 includes new obligations on investment firms and market operators operating RMs, MTFs and OTFs that are intended to enhance the resilience of such venues, particularly in relation to electronic trading. These include requirements to ensure that the venue has effective systems to ensure its trading systems are resilient, have sufficient capacity to deal with peak order and message volumes, can ensure orderly trading under conditions of severe market stress and are fully tested to ensure these obligations can be met.

In addition, trading venues must have arrangements which enable them to reject orders that exceed pre-determined volume or price thresholds or which are clearly erroneous, as well as having the ability to temporarily halt or constrain trading if there is a significant price movement (i.e. circuit breakers). There are also specific obligations placed on trading venues designed to ensure that algorithmic trading systems do not create, or contribute to, disorderly trading conditions, and to deal with any such conditions which do arise as a result of algorithmic trading, including limiting the ratio of unexecuted orders to transactions, by slowing down orders.

The requirements set out in RTS 7 apply to trading venues that allow or enable algorithmic trading through their systems. Since a trading venue is considered to allow or enable algorithmic trading 'where order submission and order matching is facilitated by electronic means' this is likely to capture many trading venues.

However, where a trading venue operates different trading systems the requirements will apply only to those systems that allow or enable algorithmic trading and not to those systems that do not permit algorithmic trading (such as voice systems).

Furthermore, the RTS state that a trading venue should apply the requirements on a proportionate basis following a self-assessment, so not all organisational requirements will need to be applied (or applied in the same way) for all types of trading systems that facilitate order submission and order matching by electronic means. In particular, the specific requirements for 'request-for-quote' or hybrid systems may differ depending on the extent to which any algorithmic trading activity is actually undertaken in those types of system.

RTS 7 set out detailed requirements to ensure that the trading systems of a trading venue are resilient and have adequate capacity. These are the equivalent arrangements for trading venues to those which apply to investment firms and include:

- the governance arrangements trading venues must have in order to establish and monitor their trading systems, including the responsibilities of the management body and senior management;
- the role of the compliance function within the trading venue, and the level of understanding the compliance function has of the way in which the algorithmic trading systems operate;
- the staffing needed by the trading venue to manage its algorithmic trading systems and the skills needed by those staff;
- the requirements applicable to outsourcing by the trading venue;
- the standards to be set by the trading venue for their members' use of the trading venue's electronic order submission systems (including, for example, whether members are permitted to allow DEA access for their clients). Trading venues will have to undertake a due diligence assessment of prospective members against these standards;
- systems testing before deployment of new or updated trading systems, as well as requirements for members to undertake testing of their systems and algorithms or strategies;
- requirements relating to the capacity of the trading venue's systems;
- real-time monitoring of the trading systems' performance and capacity; and
- measures to prevent disorderly trading conditions, such as limits on members' orders, mechanisms to manage volatility and pre-trade controls.

MiFID 2 includes provisions requiring trading venues to ensure their fee structures are transparent, fair and non-discriminatory and do not create incentives to 'place, modify or cancel orders or to execute transactions in a way which contributes to disorderly trading conditions or market abuse'. However, trading venues can impose higher fees for orders that are subsequently cancelled and on participants who place a high ratio of cancelled to executed orders or who pursue a high frequency algorithmic trading strategy. Trading venues must be able to identify orders generated by algorithmic trading, the different algorithms used for the creation of the orders and the participants initiating those orders.

Market making

MiFID 2 also contains new obligations on trading venues to put in place more formal market making arrangements, including having written agreements with all investment firms that pursue a market making strategy, and schemes to ensure that sufficient numbers of firms actually participate as market makers where this is appropriate to the nature and scale of the trading on that venue. These obligations are the corollary of those imposed on investment firms.

Trading venues will have to specify the precise contents of the market making agreements to be put in place with investment firms. However, as set out above in the section on ‘Algorithmic trading, market making and direct electronic access’, RTS 8 provide the minimum obligations for such agreements, including the minimum market making obligations in terms of presence, size and spread (which must at least require the firm to post firm, simultaneous two-way quotes of comparable size and competitive price in no less than one financial instrument on the trading venue for at least 50 per cent of the trading hours of continuous trading). In addition, the RTS set out a list of exceptional circumstances in which market making obligations will not apply (for example, extreme volatility).

The trading venue will have a separate obligation to set out a scheme of incentives for investment firms that are engaged in market making on the venue

The trading venue will have a separate obligation to set out a scheme of incentives (e.g. rebates or other forms of incentive) for investment firms that are engaged in market making on the venue. The schemes may (and the implication is that the schemes should) reward investment firms who exceed the minimum parameters as well as those who continue to provide liquidity in times of market stress.

In terms of the requirement that the market making schemes are fair and non-discriminatory, the RTS require trading venues to make the market making schemes available to all investment firms pursuing a market making strategy – in other words they cannot cap the number of market makers. However, trading venues can limit access to the incentives, but only based on whether investment firms meet the particular performance parameters or not.

However, RTS 8 provide details of when a market making scheme will not be required. In effect, trading venues will be required to put in place market making schemes only for the following classes of financial instrument when traded through a continuous auction order book trading system:

- liquid shares and liquid ETFs (where liquidity is assessed by reference to the transparency requirements in MiFIR);
- options and futures on liquid shares and ETFs; and
- liquid equity index futures and liquid equity index options (again where liquidity is assessed by reference to the transparency requirements in MiFIR).

As a result the obligations to establish market making schemes will be limited to liquid shares and ETFs and related exchange-traded futures and options and only when those instruments are traded on a continuous auction order book trading system.

Tick size regimes

Finally, there is an entirely new provision in MiFID 2 requiring trading venues to adopt minimum tick size regimes in relation to shares, ‘equity-like’ instruments and other types of specified financial instruments.

RTS 11 contain a tick size regime for shares, depositary receipts and ETFs (but only for ETFs that have as their sole underlying financial instruments equities that are themselves subject to the tick size regime).

The approach taken in the RTS is that shares and depositary receipts will be allocated to a liquidity band based on the average number of trades per day on the most relevant market in terms of liquidity in that instrument over the previous 12 months of trading. ETFs will be allocated to the liquidity band with the highest average daily number of transactions. Once an instrument has been allocated to a liquidity band, the minimum tick size will vary according to a series of 19 price ranges relating to the price of the order. Broadly, the greater the liquidity the smaller the tick size; while the higher the price range the higher the tick size.

Despite the policy objectives to promote central clearing, provisions in MiFIR relating to access to clearing have proved contentious

Non-discriminatory access to clearing, trading and benchmarks

Despite the policy objectives to promote central clearing, provisions in MiFIR relating to access to clearing have proved contentious. MiFIR introduces provisions to prevent discriminatory practices and to remove various commercial barriers that could be used to prevent competition in the clearing of financial instruments. However, the provisions are complex and the access rights to CCPs and trading venues are qualified to a certain extent.

Non-discriminatory access to clearing

MiFIR will require CCPs to accept to clear certain financial instruments from trading venues on a transparent and non-discriminatory basis, to the extent that those venues comply with the operational and technical requirements of the CCP (the 'CCP access right').

The application process involves a request to the CCP, the CCP's competent authority and the trading venue's own competent authority. Access may be denied by the CCP or by the CCP's competent authority on a variety of grounds. These include, in the case of the CCP, the anticipated volume of transactions, the number and type of users, the arrangements for managing operational risk and complexity and other factors 'creating significant undue risks'. RTS 15 set out further detail on each of these grounds.

The CCP's competent authority may refuse access where this would require an interoperability arrangement with other CCPs (in the case of exchange-traded derivatives (ETDs)), would 'threaten the smooth and orderly functioning of the markets, in particular due to liquidity fragmentation', or would adversely affect systemic risk.

In addition, newly established CCPs can apply for a transitional exemption from the open access regime in relation to transferable securities and money market instruments. The Commission must report, after the implementation of MiFIR, on whether the transitional arrangements should be extended (weighing the possible benefits to consumers of improving competition and the degree of choice available to market participants against the possible disproportionate effect of those provisions on newly established and authorised CCPs, the constraints of local market participants in accessing global CCPs and the smooth functioning of the market).

The CCP access right in MiFIR is equivalent to a provision on access to CCPs set out in EMIR, which applies to OTC derivatives (i.e. in EMIR, derivatives that are not executed on RMs). The MiFIR CCP access right will apply only in relation to access to CCPs by trading venues in relation to financial instruments other than OTC derivatives covered by the access regime in EMIR.

Non-discriminatory access to trading

As a corollary to the CCP access right, MiFIR will require trading venues to provide access on a transparent and non-discriminatory basis to CCPs that wish to clear transactions executed on the trading venue (the 'trading venue access right'). Again, the trading venue or its competent authority can refuse access to the CCP in certain circumstances.

MiFIR contains an opt-out for trading venues trading ETDs if they are below the relevant threshold of €1,000 billion notional amount traded in each year. The opt-out applies for 30 months but is renewable provided the trading venue remains below the threshold. The Commission is required to report after MiFIR comes into effect on whether the threshold remains appropriate and whether the opt-out mechanism should remain available.

Further detail on non-discriminatory access to both clearing and trading

RTS 15 cover access in respect of CCPs and trading venues and set out:

- conditions under which an access request may be denied by a CCP or a trading venue;
- conditions where granting access would threaten the smooth and orderly functioning of the markets or would adversely affect systemic risk;
- conditions under which access is granted (including confidentiality of information);
- conditions for non-discriminatory treatment in terms of how contracts traded on the venue are treated in respect of collateral requirements and netting of economically equivalent contracts and cross-margining with correlated contracts cleared by the same CCP; and
- notification procedure and calculation of notional amount with regard to transition provisions.

The RTS specify (for both CCPs and trading venues) that access may only be denied if, after making all reasonable efforts to manage the risks, there remain significant undue risks that cannot be managed. When denying access, the CCP or trading venue must identify the risks and why they cannot be managed.

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A CCP is able to deny access on a number of grounds:

- anticipated volume of transactions where this would exceed the scalable design or planned capacity of a CCP;
- operational risk and complexity, which includes incompatibility of IT systems, lack of human resources with the necessary knowledge, skills and experience to perform the CCP's functions; and
- other factors creating significant undue risks.

A trading venue can deny access on the following grounds:

- operational risk and complexity, if the risks could result in incompatibility of IT systems, impeding the trading venue providing for connectivity between those systems; and
- other factors creating significant risks such as threat to the economic viability of the venue or its ability to meet its minimum capital requirements, or incompatibility of the venue rules and CCP rules that the trading venue cannot remedy in cooperation with the CCP.

Transitional arrangements and opt-outs for non-discriminatory access to clearing and trading

In addition to the transitional exemption to the CCP access right and the opt-out to the trading venue access right covered above, there are a number of provisions in MiFIR dealing with the implementation of the open access regime across both clearing and trading.

Where a CCP secures the transitional exemption mentioned above in relation to transferable securities and money market instruments, it has the effect of removing any trading venues with which the CCP has close links from the open access regime in relation to transferable securities and money market instruments for the period of the transitional exemption.

Similarly, where a trading venue uses the opt-out for ETDs, it has the effect of removing any CCPs with which the trading venue has close links from the open access regime in relation to ETDs for the period of the opt-out.

Both open access obligations in MiFIR also contain a surprising carve-out. The CCP access right provision sets out that a CCP is not bound by the CCP access right if it is connected by close links to a trading venue that has made use of the ETD opt-out. Similarly, a trading venue is not bound by the trading venue access right where it is connected by close links to a CCP that has made use of the transitional exemption. Neither of these provisions is expressed as being limited to ETDs or to transferable securities and money market instruments (as applicable).

Therefore, on the face of the text this would appear to remove a CCP from the CCP access right altogether and not merely in relation to ETDs, or a trading venue from the trading venue right altogether and not merely in relation to transferable securities or money market instruments. It is not clear if this was the intended effect and it is hoped that ESMA may provide further guidance on this in due course.

The sensitivity surrounding access rights in relation to ETDs is reflected in a provision that permits the Commission to seek to remove ETDs altogether for up to 30 months

The sensitivity surrounding access rights in relation to ETDs is reflected in a provision in MiFIR that permits the Commission to seek, prior to MiFIR coming into effect, to remove ETDs from the scope of the CCP access right and trading venue access right altogether for up to 30 months. The Commission is required to report before MiFIR comes into effect on whether there is a need to temporarily exclude ETDs from the scope of the open access provisions for CCPs and trading venues. The Commission has not yet published its report, but ESMA has provided its risk assessment to the Commission on this point and has stated that it sees no need to temporarily exclude ETDs from the open access provisions.

Even if the Commission decides to not exclude ETDs, a CCP or trading venue may, before MiFIR enters into force, apply to its competent authority for permission to temporarily be exempt from the open access regime in relation to ETDs for a transitional period. Where the competent authority grants the temporary exemption to a CCP, trading venues with which the CCP has close links are excluded from the open access regime in relation to ETDs for the same transitional period. Similarly, where the competent authority grants the temporary exemption to a trading venue, CCPs with which the trading venue has close links are excluded from the open access regime in relation to ETDs for the same transitional period.

Non-discriminatory access to benchmarks

Finally, in order to promote competition in the trading of certain financial instruments that reference indices or benchmarks (e.g. certain futures contracts), owners of benchmarks will have to give CCPs and trading venues non-discriminatory access to information relating to the benchmark (e.g. information on the composition, methodology and pricing of the benchmark) for the purpose of clearing and trading, and will also have to license of such benchmarks on a 'fair, reasonable and non-discriminatory basis'.

However, owners of rights in new benchmarks will be permitted to refuse licences for 30 months after a financial instrument referencing that benchmark commences trading or is admitted to trading.

RTS 16 on non-discriminatory access in respect of benchmarks cover three topics:

- information through licensing to be made available;
- other conditions under which access must be granted; and
- the standards to be taken into account in establishing whether a benchmark is new.

Under MiFIR, owners of benchmarks must be permitted access to relevant price and data feeds and information on the composition, methodology and pricing of the benchmark for the purposes of clearing and trading. The RTS specify that a CCP or trading venue making a request must explain why the information is required for its clearing or trading purposes, as well as describing the functions of clearing and trading. Further, there is a list of the minimum information that is considered to be relevant.

In relation to whether a benchmark is new, the RTS set out that the assessment varies on a case by case basis and that the onus is upon the person with proprietary rights to the benchmark to demonstrate that the benchmark is new, if this is the basis on which immediate access is denied.

The standards that should be taken into account are whether contracts based on the more recent benchmark can be netted against contracts based on an existing benchmark by a CCP, whether the regions and industry sectors covered by the benchmarks are the same or similar, whether the values of the benchmarks are highly correlated and whether the composition of the relevant benchmarks are highly correlated.

A benchmark is not considered to be new where it releases a new series on a periodic basis.

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