Statement

MANAGED FUNDS ASSOCIATION

FOR IMMEDIATE RELEASE
AUGUST 1, 2014

MFA ISSUES RESPONSES TO ESMA'S CONSULTATION AND DISCUSSION PAPERS ON MIFID II AND MIFIR

WASHINGTON, D.C. (August 1, 2014) – Managed Funds Association today filed its responses to the European Securities and Markets Authority's (ESMA) consultation and discussion papers regarding the implementation of the Markets in Financial Instruments Directive (MiFID II) and the Markets in Financial Instruments Regulation (MiFIR).

MFA's comments reflect a commitment to the policy goals of MiFID II/MiFIR – to improve market transparency, to ensure depth and liquidity of markets, and to increase investor protection – while ensuring that the new, suggested rules are consistent and harmonized with those of other major jurisdictions. Among other important issues, MFA's responses focused on ESMA's questions regarding the derivatives trading obligation, straight-through-processing, transparency requirements, the definitions of algorithmic and high frequency trading, position limits, and inducements.

Addressing today's responses to ESMA, MFA President and CEO Richard H. Baker said, "As investors, MFA's members support regulatory efforts that produce safer, stronger, more efficient markets, and enhanced protection for all investors. We have endeavored to offer constructive feedback to ESMA based on investors' perspectives on the adjustments they believe are needed to result in positive changes to regulated markets."

MFA's responses concentrated on the following issues:

Derivatives Trading Obligation

MFA urges a strong role for ESMA in facilitating the transition to imposing the MiFIR trading obligation on various classes of derivatives. MFA believes that effective oversight will ease the process to mandatory trading of such derivatives on trading venues.

- MFA supports ESMA's proposed approach of retaining full oversight and control of the "liquidity" determination which ESMA must make before declaring derivatives subject to mandatory trading.

- MFA supports an expedited process for ESMA to remove derivatives from the trading obligation, along with an ongoing review process assessing the liquidity of each class. Further, an adequate phase-in period, preferably 180 days following the entry into force of the relevant implementing measures, should apply to all market participants for the introduction of the trading obligation.

- MiFIR permits non-EU counterparties to comply with an "equivalent" third country regulatory regime, but only where one of the counterparties is "established in" the relevant third country. As similar wording has created issues under EMIR, MFA supports a broad interpretation of the term "established in" that covers situations where firms are subject to the laws of the third country without actually being established there. Otherwise, firms which are subject to regimes such as the U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act may find that they are required to comply with two overlapping and potentially conflicting regimes.

Transparency Requirements

MFA seeks rules that will foster a dynamic trading environment. MFA focused its comments on transparency requirements for non-equity financial instruments. MFA urges trading on regulated trading venues and increased transparency. Nonetheless, MFA urges caution with respect to transitioning currently illiquid products to more liquid and transparent markets. Examples include:

- MFA seeks clarity regarding the application of pre-trade transparency requirements to voice trading systems. MFA respectfully urges ESMA to work with market providers to come up with a realistic and cost-effective solution to the introduction of pre-trade transparency for voice trading systems. In particular MFA seeks a pragmatic approach with respect to the requirement for voice trading systems to publish bids, offers, and actionable indications of interest through electronic means to the wider market.

- MFA is also concerned by ESMA's proposal that bids, offers and attaching volumes submitted by each "responding entity" should be subject to pre-trade transparency requirements in the context of a request-for-quote system. A defining characteristic of a request-for-quote system is that the requesting participant is the only counterparty to which the quote is disclosed. Thus, the proposed pre-trade transparency requirements would effectively turn a request-for-quote system into some other type of trading system, by eliminating one of the essential features of a request-for-quote system.

- MFA asks ESMA to adopt a targeted and sufficiently calibrated definition of the term "liquid market." MFA seeks transparency requirements for products that are truly liquid, but supports an effective system of pre-trade transparency waivers and post-trade transparency deferrals for illiquid products and for transactions which are large in scale.

- MFA asks ESMA to develop specific coverage ratios for sub-categories of financial instruments, provided they are set and phased in appropriately. MFA supports a sufficient level of granularity in establishing sub-categories of instruments to ensure that ESMA sets the ratios at an appropriate level.

- MFA supports ESMA's adoption of an adequate review process into liquidity assessments, given that the liquidity profile of any given class of instruments can change quickly over time.

Straight-Through-Processing (STP)

MFA strongly supports mandating STP, as MFA believes it will benefit the European cleared derivatives markets by leading to the development of more secure and efficient markets.

- MFA encourages ESMA to introduce new definitions in the context of Article 29 of MiFIR, allowing for differentiation of derivative contracts based on whether they are executed on a trading facility or bilaterally. Given that the systems, procedures, and arrangements supporting the flow of information to central counterparties (CCPs) differ based on where a derivative contract is executed, MFA believes it is important for ESMA to distinguish among derivative contracts executed on an exchange, trading venue, platform, organized trading facility (OTF), multilateral trading facility (MTF), or other facility, and bilaterally negotiated OTC derivative contracts. In each case, MFA supports the standard which applies to the submission process is "as quickly as technologically practicable" in accordance with Article 29 of MiFIR.

- MFA advises ESMA that any perceived timing mismatch in the transfer of margin should not be regarded by ESMA as a justification for delaying the process of submitting and accepting derivative contracts for clearing or requiring pre-funded margin.

- MFA asks ESMA to mandate a ten-second period as the maximum period allowed to a CCP for acceptance or rejection of a trade.

Regulation of Algorithmic and High Frequency Trading

As technology advances, market regulation must ensure that trading achieves its fundamental economic function. Accordingly, MFA advocates the following:

- MFA does not believe that ESMA needs to define "high frequency trading technique." We believe it would be more effective for ESMA and competent authorities to monitor the markets for abusive trading rather than the means of transaction delivery. Nonetheless, if ESMA determines that it is necessary to define "high frequency trading technique", it should take into consideration a high message intraday rate, a median daily lifetime of orders test and flat or near-flat end-of-day positions.

- MFA supports a principles-based regime that allows market participants to calibrate and customize the risk controls and testing of their algorithms. When it comes to risk controls and testing of individual algorithms, one size does not fit all. Regulators should avoid overly prescriptive requirements, which could lead to a more unsafe rather than safer marketplace.

Organizational Requirements for Trading Venues

Trading venues play a significant role in maintaining the soundness and stability of the marketplace, thus, accordingly:

- MFA supports ESMA's proposal that trading venues monitor their performance in relation to matters such as gateway-to-gateway latency, matching engine progress, percentage of maximum message capacity used per second and number of trades executed per second. Further, ESMA should consider whether latency providers should be required to disclose information on the quality of their services.

- Market participants need trading venue rules with respect to cancelling, varying or correcting transactions to be clear and predictable, with limited administrative discretion. Also, such policies should apply consistently across market participants, regardless of whether trading is automated or manual.

- MFA supports pre-trade risk controls as they serve to prevent or minimize market disruptions during times of market stress, help restore confidence in the markets and limit harm to customers. In regulating pre-trade risk controls, however, MFA firmly believes that trading venues need to have the flexibility to be able to fine-tune risk controls to their markets.

- MFA supports the provision of testing facilities by trading venues, but cautions against regulations prescribing testing procedures. Testing must be properly calibrated to individual algorithms or trading strategies.

Position Limits

MFA urges practical application of position limits to minimize cost and to ensure that markets are dynamic.

- MFA supports a position limits methodology that uses open interest rather than deliverable supply as the baseline for position limits relating to cash settled contracts, as cash-settled and physically-settled transactions are not interchangeable.

- MFA requests that ESMA publish clear guidance on when transactions will be classed as being "economically equivalent" to commodity derivatives traded on trading venues. The criteria for economic equivalence should be expressed in a precise manner and extend only to a narrow and well-defined set of transactions. Such guidance would reduce the risk that a market participant's analysis of whether a contract is "economically equivalent" differs from the view of its national competent authority.

- MFA believes market participants should have a degree of flexibility in determining whether transactions are appropriate to be offset with regard to netting positions.

- Market participants should be given at least twelve months lead time for implementation of the position limits regime, with subsequent notice periods of at least six months prior to any change in the level of position limits in order to avoid market disruption. Position limits should be fixed for a twelve or twenty-four month period to provide greater market stability as market participants often invest or hedge based on longer-termed strategies.

- MFA supports ESMA's proposals for position limits reports to be submitted on a T+1 basis and for reporting to be aligned with EMIR where possible. MFA believes ESMA should expressly allow for reporting via third parties and that confidentiality safeguards should apply where end clients' positions are being reported.

Inducements

MFA believes that professional investors should have choices regarding how they pay for research, within the confines of the Level 1 text.

- MFA believes investment research plays an extremely important role in the investment management industry and it is only appropriate that, for any policy decisions relating to this topic, thorough consultation and extensive study/survey should be conducted to gain a comprehensive understanding of the market. MFA urges ESMA to consider delaying any such proposals for unbundling pending completion of empirical study.

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- MFA is concerned that the practical effect of ESMA's unbundling proposal, particularly given the proposed broad definition of research that covers bespoke research, access to analysts, meetings, and analytical models would be that most of the benefits received by portfolio managers that may be in the best interest of their clients would be prohibited from being obtained through dealing commissions. Further, the bundled services model often enables managers to negotiate better pricing with their brokers. Forcing managers to negotiate separately on research may lead to an increase in the overall costs passed on to clients.

Best Execution

- MFA does not believe that it is proportionate to require investment firms to publish an annual summary of their internal execution quality monitoring. Investment firms are already subject to detailed reporting requirements on execution. This does not appear to provide any additional benefit and it also risks duplicating information already provided.

MFA remains committed to working with European policy makers and regulators throughout the MiFID II/MiFIR Level 2 process, and looks forward to reviewing ESMA's further advice to the European Commission and its consultation paper on technical standards later this year.

For more information on MFA's views regarding MiFID II/MiFIR please visit our website: http://www.managedfunds.org/issues-policy/eu-legislative-priorities/review-markets-financial-instruments-directive-mifid-ii-markets-financial-instruments-regulation-mifir/

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