

The Impact of MiFID on Cross-Border MTFs for Professionals

The purpose of this article is to examine whether regulatory changes under the Markets in Financial Instruments Directive 2004/39/EC (“MiFID”) will contribute to the removal or reduction of regulatory barriers to the expansion and development of alternative electronic trading platforms within the EEA and globally.

Electronic trading platforms enable efficient and reliable cross-border communication of price information and transaction execution on a global scale. Their development has encouraged the professionals’ market for global trading of financial instruments such as interest rate products, commodity derivatives and currency. Equity trading may be more parochial but while shares in small to mid cap companies may naturally trade domestically shares in large cap companies also trade extensively cross-border and globally (particularly when they are dual listed or have sponsored ADR programmes). Progress made with international product identification standards and interface protocols have sponsored continued development of global electronic trading platforms. However, national regulations have proved a constant source of frustration to platform operators seeking to provide cross-border services and the professionals wishing to use these platforms to trade cross-border with each other.

Regulatory changes to be introduced by MiFID have been promoted on the basis that they will lead to a step change, at least in the EEA, in the competitive position of alternative electronic trading platforms by reducing regulatory restrictions on market access.¹ But is MiFID in fact a measure which will result in the reduction of the regulatory burden upon electronic trading platforms or a reduction in regulatory barriers to their efficient cross-border operation?

Impact upon EEA MTFs

To consider the impact of MiFID the starting point is to consider its stated objectives. The recitals to MiFID provide that it is intended to establish a comprehensive regulatory regime governing the execution of transactions in financial instruments irrespective of the trading methods used to uphold the integrity and overall efficiency of the financial system. The recitals go on to provide that it is “necessary to recognise the emergence of a new generation of organised trading systems along side regulated markets which should be subjected to obligations designed to preserve the efficient and orderly function of financial markets” and that “with a view to establishing a proportionate regulatory framework” provision was made for the inclusion of a “new investment service” which relates to the operation of an multi-lateral trading facility (“MTF”). The MiFID recitals do not contemplate the reduction of regulatory barriers to facilitate and encourage alternative electronic trading services as such: to the contrary they contemplate more regulation of such services. At the time MiFID was settled these measures were considered necessary by established national stock exchanges who perceived that they were unfairly subject to heavier regulation than the new and relatively inexpensive generation of alternative electronic trading

¹ Keynote Commissioner McCreevy MiFID Conference 30 June 2006

platforms. Those that had argued that there was no need to create a new regulatory category of investment service for these increasingly sophisticated and efficient electronic brokerage systems (which mounted a serious challenge to established stock exchanges) had lost that debate.

As a result under MiFID what sets apart an intermediary that provides its service by way of an MTF from any other intermediary is that in addition to meeting the regulatory requirements imposed on other intermediaries generally it must also establish:

- transparent and non discretionary rules and procedures for fair and orderly trading;
- objective criteria for the efficient execution of orders;
- transparent rules regarding the criteria for determining the financial investments it will trade;
- transparent rules, based on objective criteria, governing access to its facility;
- the necessary arrangements to facilitate the efficient settlement of transactions concluded under the MTF systems;
- effective arrangements and procedures for the regular monitoring of the compliance by its users with its rules in order to identify rule breaches, disorderly trading conditions or conduct that may involve market abuse.
- arrangements to publish (on commercial terms) detailed pre-trade and post trade price information on listed securities advertised on its system.

The above represents an increase in regulatory burden. It may be that most of these additional regulatory requirements will coincide with sound commercial practice or will not be difficult to implement but they certainly do not represent any reduction of regulatory barriers for these platforms and their professional users.

Proponents of MiFID reference the MiFID regulatory changes which will mean that in some EEA countries trading in shares will not be the sole prerogative of the local stock exchange and that share trading on alternative electronic trading platforms/venues will be enabled. Following implementation of MiFID such “concentration” obligations should disappear but the impact of this reform is exaggerated given that it only relates to a few peripheral equity markets. More than 75% of trading in European equities occurs on the LSE, Euronext and Deutsche Borse which are not subject to concentration rules.

One of the main market entry barriers faced by MTFs in the EEA, with respect to equity and government bond trading in particular, is competitive access to clearing and settlement services. A lack of open access to fungible clearing arrangements and central counterparty services in the EEA has favoured incumbent national exchanges. While MiFID contains provisions that prohibit Member State restrictions against rights of access to central counterparty, clearing and settlement systems in their territory to intermediaries from other Member States for the most part these provisions confirm existing EC law which prohibits such discriminatory access arrangements. The elimination of these barriers to competition will involve a range of measures which the European Commission is actively pursuing but which are not to be found in MiFID. A number of proposals have recently been suggested to address the range of anti-competitive restrictions and practices which currently exist in the EEA securities clearing and settlement market.²

² (See European Commission Competition DG “Competition in EU Securities Trading and Post Trading Issues Paper” 24 May 2006).

Proponents of MiFID might also refer to the establishment of MTF passport rights under MiFID which will enable an electronic trading platform operator incorporated and authorised in one jurisdiction to freely provide its services throughout the EEA. However, the provision of cross-border trading services within the EEA is readily achievable under the existing Investment Services Directive ("ISD"). A firm that operates an MTF is a firm engaged in the regulated activities of the reception and transmission of orders, and of their execution, which activities benefit from the passport provisions of the ISD.

One of the better known examples of a European electronic trading platform for professionals is EuroMTS which operates in reliance upon the ISD passport throughout Europe for the electronic trading of European government bonds. EuroMTS is an off-shoot of the Italian MTS which is an electronic Italian government bond trading platform regulated as an exchange in Italy. EuroMTS is incorporated in the United Kingdom and is regulated as an investment firm. EuroMTS is authorised to arrange deals in investments and deal in investments (as agent or principal) and relies on the ISD passport provisions to offer its services throughout the EEA.

The only impact MiFID will have on EuroMTS is that it will have to seek permission to act as an MTF operator so that it will rely on the specific MTF passport to offer its cross-border services. MiFID will not result in any greater ability for EuroMTS or any other similar electronic trading platform to operate in the EEA.³

Impact upon Non EEA MTFs

Currently many electronic trading platforms established and regulated in non EEA jurisdictions for example, in the United States, offer services in the EEA through an affiliate intermediary regulated and authorised in an EEA member state, most commonly in the UK where it will be regulated by the Financial Services Authority ("FSA").

The UK affiliate obtains authorisation to carry out the activity of arranging transactions because this enables the trading service to be offered to persons who are located in other EEA Member States using the "passport rights" conferred by the ISD. The relevant passport rights are defined as the right to provide a cross-border service consisting of (i) the "reception and transmission, on behalf of investors, of orders"-order routing- in relation to the financial instruments listed in the ISD and (ii) the "execution of [orders received and transmitted on behalf of investors] other than for own account".

The difficulty that MiFID may create for this commonly adopted structure is that the EEA affiliate may be considered an MTF operator in which case it will be obliged to obtain authorisation as an MTF operator and be responsible for ensuring compliance with the additional regulatory burden imposed upon MTF operators by MiFID (which regulations were intended to regulate an MTF in a similar way to more established national exchanges). At the same time the trading platform may also be treated as established in the home state of the parent company operator and subject to a set of regulations, such as in the US, for alternative trading systems but which are different to the MiFID requirements. The result is a single global trading platform being regulated as if it had two responsible market operators with two different sets of regulation. If such a regulatory outcome were permissible (given the artificial construct of two responsible operators for a single trading system) it is at best unsatisfactory.

³ Euro MTS benefits at the expense of other MTF's from the Italian government's anti-competitive designation of Euro MTS and MTS as the only platforms on which trading volumes required for primary dealer status in Italy count. (MTS was originally founded by the Italian central bank). This practice is not addressed by MiFID.

Alternatively, to avoid the need for the EEA affiliate to be regulated as an MTF, and thus subject the trading platform to two sets of potentially conflicting regulations, it may be possible to limit the regulated activities of the EEA affiliate to "making arrangements with a view to transactions" (which in the UK the FSA considers covers persons providing only part of the communication facilities for order routing). Such activities can then reasonably be characterised as limited to the passport activity of order routing. The activity as so defined would not extend to the execution of orders or arranging their execution for which authorisation as an MTF operator would be required. In the case of an electronic trading platform operated by a person outside the EEA, the execution (or arrangements for execution) occur outside the EEA at the location of the servers upon which the matching engine of the platform operates.⁴

In these circumstances, however, there may be doubts about whether the EEA affiliate actually participates in the receipt and transmission of orders input by EEA investors on an electronic communication network which links directly to a matching engine operated by the overseas parent company. It has been suggested that unless the EEA affiliate manually intervenes in the electronic communication process it will not be order routing (receiving or transmitting orders) to the overseas matching engine and the overseas platform operator will not be able to rely on the affiliate's authorisation to deal with EEA customers. However, any obligation to have such manual intervention would completely undermine the benefits of a global electronic trading platform.

In the case where the UK affiliate (a) has responsibility for the provision of local leased communication lines between EEA customers and a local UK communications hub; (b) the licencing of front-end /GUI software to the customer; and (c) the execution of terms of business with the customer in which orders are deemed to be routed through the UK affiliate; and the UK affiliate stipulates terms with regard to authorised users, passwords and access security generally then it is reasonable to contend that MiFID passport rights for receiving and transmitting orders (not as an MTF operator) could be relied upon to enable the platform to operate throughout the EEA. Whether in fact EEA regulators will accept this proposition is uncertain.

Conclusion

With the possible exception of some domestic EEA equity markets MiFID does not remove or reduce any regulatory barriers for the development of electronic trading platforms rather it adds to the regulatory burden of such platforms within the EEA. The continuing development of electronic trading platforms at the expense of traditional execution venues may occur but if it does so this may have little to do with the regulatory changes introduced by MiFID. The European Commission may be heralding MiFID as a measure which will produce a step change for EEA MTFs but achieving progress with respect to the application of EU competition policy to the clearing and settlement services market in the EEA, as discussed above, should be recognised as rather more important in this regard.

For platforms operated from outside the EEA through an affiliate incorporated and authorised in an EEA member state their ability to offer services to EEA professionals may have been further restricted by MiFID or at best have been made more complicated or uncertain than at present. The European Commission may be lobbying for the evolution into a converged system of mutual recognition of the US and European best execution requirements but there is a prior more fundamental issue to be addressed, namely, the facilitation of access for global MTF platforms to EEA professional investors so that such venues can be utilised to achieve best execution.

⁴ Generally the EC considers that the territory where an activity takes place is the place of "characteristic performance" and that services provided by remote communication (electronic communication network) cannot be deemed to be the pursuit of that activity in the customer's territory. Nevertheless certain activities such as order routing (by remote communication or otherwise) may be considered to take place in the territory of the customer.

