Equity Trading and the MiFID Review: Law, Market Change and Interest Groups in EU Financial Markets*

1. Introduction

1.1 *Introduction*

The application of MiFID I[1] to the EU's equity trading markets in November 2007 heralded a new era for EU financial markets.[2] MiFID I's equity trading market rules (or the order execution (trading) rules governing the process whereby shares are traded between market participants and on different types of trading venue) were designed to reshape the EU trading market. MiFID I abolished the earlier 'concentration' rule which allowed Member States to require that equity orders were routed to national stock exchanges.[3] It sought to use law to impose competitive discipline on the EU's incumbent stock exchanges and to harness the industry innovations and technological advances which were generating new trading venues. This reform was the most radical, ambitious and avowedly market-shaping (as compared to market-facilitating[4]) of the 1999-2004

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1 The Markets in Financial Instruments Directive (MiFID) 2004/39/EC O.J. 2004, L145/1, MiFID Level 2 Commission Directive 2006/73/EC O.J. 2006, L241/26, and MiFID Level 2 Commission Regulation (EC) No 1287/2006 O.J. 2006, L241/1. A list of the sectoral acronyms used in this article can be found at the end.

2 From a massive literature see generally: Gomber and Chlistalla, MiFID – Catalyst for a New Trading Landscape in Europe? (2007), available at http://ssrn.com/abstract=1134763; Davies, Dufour and Scott-Quinn, 'The MiFID: Competition in a New European Equity Market Regulatory Structure' in Ferrarini and Wymeersch (eds), Investor Protection in Europe. Corporate Law Making, the MiFID and Beyond (Oxford University Press, 2006), 163; Alemanni, Lusignani and Onado, 'The European Securities Industry: Further Evidence on the Roadmap to Integration' in ibid., 199; and Ferrarini and Recine, 'The MiFID and Internalisation' in ibid, 235.

3 It was most associated with France, Germany, and Italy.

4 On market-shaping and market-facilitating capitalism in the EU see Buckley and Howarth, 'Internal Market Gesture Politics? Explaining the EU's Response to the Financial Crisis.' 48 *Journal of Common Market Studies* (2010) 119 and Quaglia, Eastwood and Holmes, 'The Financial Turmoil and EU Policy Co-operation in 2008', 47 *Journal of Common Market Studies* (2009) 63.

Financial Services Action Plan (FSAP) period and generated intense interest internationally.[5]

Some four years or so of experience with MiFID I have now been gained,[6] albeit in turbulent equity market conditions. Major empirical studies are appearing.[7] The massive MiFID Review, scheduled at the time of MiFID I's adoption, is underway. In summer 2010 CESR (the Committee of European Securities Regulators – now the European Securities and Markets Authority) presented its Advice to the Commission on the Review.[8] The Commission's initial Consultation was presented in December 2010.[9] The much anticipated MiFID II proposals were published on October 20, 2011.[10] The time is therefore ripe for a consideration of MiFID I and the Review process.

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5 US Securities and Exchange Commission (SEC) Commissioner Campos stated that 'it is not an overstatement to say that [MiFID] will markedly change the regulatory landscape in Europe and globally. It will be a new global frontier': Speech on 'The Challenge of MiFID in the United States' Amsterdam, 10 May 2007, available via http://www.sec.gov/news/speech/2007.

6 Eg: Valiente and Assi, MiFID Implementation in the midst of the Financial Crisis. ECMI Research Report No 6 (2011); Soltani, Minh Mai, and Jerbi, Transparency and Market Quality: An Analysis of the Effect of MiFID on Euronext (2011), available at http://sssrn.com/abstract=1833605; Lazzari (ed), Trends in the European Securities Industry (egea, 2011); Gresse, Multi Marketing Making and Market Quality (2010); Petrella, 'MiFID, Reg NMS, and competition across trading venues in Europe and the USA' *Journal of Financial Regulation and Compliance (*2010) 257; and Lannoo and Valiente, The MiFID Metamorphosis, ECMI Policy Brief No 16 (2010).

7 Eg, CFA Institute, The Structure, Regulation and Transparency of European Equity Markets under MiFID (2011) (the CFA 2011 Report); MiFID: Spirit and Reality of a European Financial Markets Directive (2010) (Report by Gomber (Goethe University) and Pierron (Celent)) (the Celent Report); London Economics, Understanding the Impact of MiFID in the Context of Global and National Regulatory Innovation (2010) and (2011), each for the City of London Corporation (London Economics (2010) and (2011); and Lazzari *supra* note [*]. The Commission has also commissioned a series of studies, outlined in the MiFID II Impact Assessment (*supra* note [*]).

8 CESR/10-802 (Consultation Paper at CESR/10-394 and Feedback Statement at CESR/10-975). The Advice reflected an earlier June 2009 study on the equity markets (CESR/09-355). The industry responses to the Consultation referenced in this article are available at http://www.esma.europa.eu/index.php?page=groups&mac=0&id=61.

9 Commission, Public Consultation. Review of the Markets in Financial Instruments Directive (the Commission 2010 Consultation). The industry responses to the Consultation referenced in this article are available at http://ec.europa.eu/internal_market/consultations/2010/mifid_en.htm.

10 COM (2011) 652/4 (the Proposed MiFID Regulation), COM (2011) 656/4 (the Proposed MiFID Directive), and Impact Assessment (COM (SEC (2011) 1226).

The purpose of this article is to examine the MiFID equity trading market regime[11] from regulatory design and interest group perspectives. It considers how MiFID I shaped the EU trading marketplace and how the dominant interests which shaped MiFID I fared. It also examines how those interest groups are seeking to shape MiFID II and the implications. This section 1 introduces the interest group analysis. Section 2 considers the key MiFID I trading venue classification system. Section 3 examines the impact of MiFID I on the markets and the related interest group 'winners and losers'. Section 4 considers the MiFID Review and interest group reaction. Section 5 considers the lessons for the MiFID II proposals. Section 6 concludes.

1.2 *MiFID, Law Reform and Interest Groups*

Why address equity market trading, given the current preoccupation of EU and international regulatory reform with financial stability? The equity trading markets proved reasonably resilient from a systemic perspective over the crisis.[12] Reform efforts concerning trading are largely related to the bond markets and the over-the-counter (OTC) derivatives market.[13] But the MiFID Review and the MiFID II proposals are important from three perspectives in particular.

First, life goes on and the massive EU regulatory regime for financial markets requires continual reform and renewal, even as the crisis-era reform agenda, focused on financial stability, approaches completion.[14] The MiFID I trading market regime is of

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[11] This article does not address the extensive MiFID II reforms which will impose transparency requirements on non-equity classes for the first time, as they raise a distinct set of issues. The MiFID II proposals suggest that the equity market transparency regime will be extended to trading in bonds, structured finance products, and derivatives. The new regime will be calibrated by means of delegated rules to reflect the liquidity and other risks which transparency requirements can pose for trading in non-equity securities, and waivers will be available based on, first, the market model used for trading, the specific characteristics of trading activity, and liquidity, and, second, the type and size or orders and the method of trading.

[12] Eg, FSA, The FSA's Markets Regulatory Agenda (2010), 4 and 19, noting that trading platforms were able to cope with the related market volatility volume and SEC, Release No 34-61358, Concept Release on Equity Market Structure (2010), 64, noting that, from an operational perspective, the equity markets performed well in Autumn 2008.

[13] Eg, Anand, 'Is Systemic Risk Relevant to Securities Regulation' 60 *University of Toronto Law Journal* (2010) 941.

central importance to the efficiency of the share price formation process, forms part of the regulatory super-structure which supports capital-raising and resource allocation between capital-seeking companies and capital-providing investors, and has implications for effective corporate governance.[15] But the costs of reform are likely to be significant. The Impact Assessment for the MiFID II proposals estimates the one-off costs of MiFID II compliance (including all MiFID reforms, not only those related to trading) as in the region of €512 to €732 million, and the ongoing costs as in the region of €312 to €586 million.[16] While these costs are lower than the costs of MiFID I,[17] they remain significant. The recovery of the EU economy is accordingly related to the extent to which EU equity trading markets operate efficiently and the MiFID Review is effective.

Second, at the heart of the MiFID Review is a question of central importance for the crisis-era reform movement internationally: how wide should the regulatory perimeter be cast? [18] The defining question of the Review for equity market trading is the extent to which EU law should pull a wider range of trading venues in to the regulatory net and, in particular, mandate that previously 'dark' equity trading (which is not disclosed to the market) becomes 'lit' (subject to disclosure obligations). This seemingly arcane question raises fundamental questions concerning the extent to which EU law can or should dictate investor choice and the shape of EU equity market trading (sections 2 and 5 below).

Third, and finally, the MiFID Review is a major test for the EU's re-constituted law-making process[19] post-crisis.

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14 Eg, Commission, Regulating Financial Services for Sustainable Growth, A Progress Report – February 2011 (2011) and Commission, European Financial Stability and Integration Report (2011) (SEC (2011) 489); and Mülbert and Wilhelm, 'Reforms of EU Banking and Securities Regulation after the Financial Crisis' 26 *Banking and Finance Law Review* (2010) 187.

15 The Commission's recent Green Paper on Corporate Governance, eg, relates what it regards as increasing short-termism, and a corresponding lack of engagement by institutional investors, to trading developments: Commission, Green Paper. The EU Corporate Governance Framework (COM (2011) 164).

16 Impact Assessment, *supra* note [*], 64.

17 *Ibid*.

18 Eg IOSCO, Task Force on Unregulated Markets and Products. Implementation Report (2011).

19 See, eg Moloney, 'EU Financial Market Regulation After the Global Financial Crisis: 'More Europe' or More Risks'? 47(5) *Common Market Law Review* 1317 and Ferran, Understanding the Shape of the New Institutional Architecture of EU Financial Market Supervision (2010), available via http://ssrn.com/abstract=1701147.

The law-making complexities[20] are considerable. MiFID I, more than most EU financial regulation, attempted to restructure the EU marketplace. It relied on regulatory venue classification techniques to do so. But one of the lessons of MiFID, highlighted *infra*, has been that fine distinctions between, for example, 'discretionary' and 'non-discretionary' trading, and between 'bilateral' and 'multilateral' trades, can lead to unexpected outcomes. The empirical evidence can be unclear and contradictory. Particular difficulties have arisen concerning OTC trading, given the poor quality of data on the scale of the OTC markets and the controversy which attends this issue, as discussed *infra*. The need for greater and better empirical evidence has been a constant theme of industry responses to MiFID Review consultations.[21] Technological developments are also of central importance in this area. But the risks of regulatory 'capture by complexity,' associated with the financial crisis,[22] are considerable. Technological developments can also speedily render reforms obsolete or play an overly-influential role, leading to overly-detailed rules which attempt to 'future-proof' reforms.

International developments may also complicate the law-making process. As discussed *infra*, the core question for MiFID II with respect to the equity trading markets is the treatment of dark (undisclosed) trading. Dark equity trading has recently attracted close international attention, reflecting increasing dark trading levels worldwide, and particularly in the US.[23] The US SEC, the Australian ASIC, and the Canadian securities industry all produced major consultations in 2010,[24] while the SEC and the UK FSA

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[20] The SEC, in its 2010 Equity Market Report, noted that 'market structure issues are complex and require a broad understanding of statutory requirements, economic principles and practical trading considerations': *supra* note [*], 8.

[21] Eg, AFME (Association for Financial Markets in Europe)/BBA (British Bankers' Association), Response to CESR/10-394 and FESE, Response to Commission Consultation, 4 April 2011 (noting the limited empirical data in the Commission's 2010 Consultation and comparing it unfavourably with the SEC's 2010 Concept Release (*supra* note [*]).

[22] Gerding, 'Code, Crash and Open Source: the Outsourcing of Financial Regulation to Risk Models and the Global Financial Crisis' 84 *Washington University Law Review* (2009) 127.

[23] SEC, Release No 34-60997, Regulation of Non Public Trading Interests (2010), 6-7.

[24] SEC, *supra* note [*] (looking at 'undisplayed liquidity' as well as other structural issues) and SEC, *supra* note [*]; ASIC, Consultation Paper 145, Australian Equity Market Structure: Proposals (2010); and CSA/IIROC, Joint Position Paper 23-405, Dark Liquidity in the Canadian Market (2010).

hosted an international roundtable on this issue in October 2011.[25] Some degree of transplantation can be useful in the reform process. Trading transparency regulation, however, is not easily transplanted, as regulation must reflect local market microstructure. Over the MiFID Review, considerable EU policy attention has focused on the US approach and in particular on the SEC's 2010 reports on dark trading. But although there is some evidence of trading market models converging between the US and the EU,[26] the foundation US 'Regulation NMS', which reflects the longstanding 1975 Congressional mandate to the SEC to construct a 'National Market System', takes a different and more interventionist approach to trading market regulation than MiFID I.[27] Regulation NMS requires, for example, the disclosure of standardized transparency information in a consolidated information feed; MiFID I, however, relies on market dynamics to consolidate transparency information. There are dangers, therefore, in borrowing from the US model. These were well-illustrated by the industry fracas which broke out when CESR's 2010 Advice and the Commission's 2010 Consultation proposed that investment firms/brokers be required to convert into a particular form of regulated trading platform (a multilateral trading facility (section 2)) when their trading volumes reached a certain threshold, following the US approach.[28] This proposal was transplanted without extensive evidence and justification – certainly by comparison with the related SEC reports. The transplantation also did not reflect the different regulatory classification model on which the US regime was based and would, therefore, have imposed a new business model on the EU investment firm market.[29] Although the final October 2011 MiFID proposals did not adopt this approach, its initial adoption underlines the risks of transplantation. There also some signs that some Member States, particularly France, may use the current international G20/IOSCO discussions on equity trading (in

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[25] SEC Press Release 2011-209.

[26] Lannoo and Valiente (2010), *supra* note [*], 3.

[27] Eg, Petrella (2010), *supra* note [*], and Gadinis, 'Market Structure for Institutional Investors: Comparing the US and EU Regimes' 3 *Virginia Law & Business Review* (2008) 311.

[28] SEC, *supra* note [*].

[29] As was frequently noted during CESR's consultation. Eg, Barclays and Citigroup, Responses to CESR/10-394.

2011 IOSCO adopted Principles for Dark Liquidity[30]) to pursue particular national agendas (section 3). The European Parliament has similarly linked the MiFID Review to the G20's agenda to address non-regulated sectors and to reinforce trust in markets post-crisis,[31] while the Commission linked the December 2010 Consultation to the G20 agenda.[32]

Interest groups, however, are likely to be the defining influence on the quality of Review. It is axiomatic that private interests exert significant influence on financial market regulation; an extensive literature examines how interest groups engage with domestic legislators[33] and international standard setters.[34] In the EU, interest group dynamics are complicated by the inter-institutional and political dynamics between the co-legislators (ECOFIN and Parliament), the Commission, and the Member States, and the interaction between these institutions and private interests; this interaction has important implications for financial regulation.[35]

The MiFID Review is particularly suited to an EU interest group analysis. As MiFID I sought to re-allocate the benefits of equity market trading across market actors, it provoked the most bitter and complex negotiations to have taken place in EU financial market regulation pre-crisis, and led to fierce clashes between the incumbent stock exchange industry and the brokerage/OTC sector.[36] The former sought to protect their position from competition and to concentrate equity orders on exchanges or, failing

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[30] IOSCO (2011), *supra* note [*], reflecting IOSCO, Issues Raised by Dark Liquidity, Consultation Report (2010).

[31] European Parliament, Resolution on Regulation of Trading in Financial Instruments (2010) (P7_TA (2010) 0466) (European Parliament Resolution).

[32] Commission Consultation, *supra* note [*], 6.

[33] Eg, Coates, 'Private versus Political Choice of Securities Regulation: A Political Cost/Benefit Analysis' 41 *Virginia Journal of International Law* (2001) 531

[34] Eg, Barr and Miller, 'Global Administrative Law: The View from Basel' 17 *European Journal of International Law* (2006) 15.

[35] From a political science perspective, see Quaglia, 'Setting the Pace? Private Financial Interests and European Financial Market Legislation' 10 *BJBIR* (2008) 46.

[36] From an extensive literature, Moloney, EC Securities Regulation (2 ed, Oxford University Press, 2008), 769-778 and Ferrarini and Recine, *supra* note [*].

which, to impose similar rules on off-exchange trading venues. The brokerage/OTC lobby argued that their execution functionality was different to that of exchanges, and that the imposition of similar rules would generate risks and costs of such magnitude that this business would become unsustainable, with consequent damage to innovation and investor choice. This industry chasm was reflected in intense ECOFIN and Parliament negotiations which responded to the entrenched negotiating positions of the exchange and investment firm/OTC lobbies and related national interests.[37]

This context led to MiFID I's venue classification system, discussed in section 2, which attempts to capture different trading functionalities in an attempt to liberalize the EU order execution market. The effectiveness of this classification system is now at the heart of the MiFID Review. The MiFID II discussions are accordingly seeing a re-enactment of the exchange/OTC division which dominated MiFID I. The relevant industry interests have, however, become more complex given in particular the emergence of new trading market actors and the strengthening of a number of trade associations.[38] In addition, while industry positions tend to coalesce around three major sectors - brokerage/OTC, trading/organized venues, and buy-side (end investors) - these groups are not monolithic and can reflect local market features. The London Stock Exchange, for example, tends to take a more sanguine approach to OTC equity trading than the Federation of European Securities Exchange (FESE), reflecting the historic importance of 'off-book' execution on the Exchange and the predominance of centralized 'on-book' order book execution on continental exchanges. The consumer interest, always problematic, is finally becoming more vocal with the emergence of new stakeholders in the wake of the financial crisis, including Euroshareholders.

The institutional interests are also complex. The European Parliament is resurgent, following some notable victories concerning the crisis reform agenda,[39] while

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[37] Ferrarini and Recine, *supra* note [*].

[38] The AFME (Association for Financial Markets in Europe), eg, was established in 2009 from a merger of LIBA (the London Investment Banking Association) and the European arm of SIFMA (the Securities Industries and Financial Market Association).

[39] Including with respect to the contested Alternative Investment Funds Manager Directive: Ferran, 'After the Crisis: the Regulation of Hedge Funds and Private Equity Funds in the EU' 12 *European Business Organization Law Review* (2011) 379.

the Commission might be regarded as fighting a rearguard action to protect its position as independent and expert technocrat, following the establishment of ESMA and the closer involvement by ECOFIN and its supporting committees in financial regulation.[40] CESR/ESMA, the Parliament, and the Commission have all been early movers in the MiFID Review, along with some Member State regulators, notably in France[41] and the UK.[42]

Given the unusually close connection between MiFID and interest groups, an interest group analysis of the MiFID I 'winners and losers' can shed light on whether and how MiFID I reallocated the benefits of equity market trading, and so inform the MiFID Review. It can also expose the weaknesses of the MiFID Review process. More generally, an interest group analysis can shed light on the contested relationship between legal change and market change, which is of central importance to the debate on EU financial market regulation, by examining whether MiFID I did have transformative effects and whether interest groups can shape legal rules and their outcomes.[43]

2. MiFID I: a complex compromise between competing interest groups and dark and lit trading

2.1 *Trading Venues and Dark and Lit Trading*

Equity order execution can take place on a number of trading venues. A broad distinction can be made between two types; (i) formal, multilateral (in that the venue acts as a platform which brings together multiple third party orders), non-discretionary (in that trades are executed according to the venue's pre-set rules or parameters) and lit (in that trading orders/interest are disclosed to the market); and (ii) informal, bilateral (between

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[40] Moloney, 'The European Securities and Markets Authority and Institutional Design for the EU Financial Market – A Tale of Two Competences: Part (1) Rule-Making' 12 *European Business Organization Law Review* (2011) 41.

[41] Eg, AMF, What are the Priorities for Financial Markets? (2011).

[42] FSA, *supra* note [*].

[43] Armour and Lele, Law, Finance and Politics: The Case of India (2008), available via http://ssrn.com/abstractid=1116608

the venue and the client), discretionary (in that trades take place at the venue's discretion) and dark (trading interest is not publicly disclosed).

The first venue type is associated with formal organized markets, including traditional stock exchanges but also newer multilateral platforms, which support non-discretionary, multilateral trading on which third party orders interact. These venues are predominantly associated with lit trading: the market is informed of levels of trading interest pre- and post-trade. This form of trading is price-setting, in that the interaction of lit orders feeds into the wider price formation process. Multilateral platforms are typically regulated as central to the price formation process, and so are subject to extensive transparency rules, or rules which require the disclosure of pre-trade bid/offer prices and post-trade trade price, volume and time information. They are also, as systemically significant venues, typically subject to authorization, organizational, capital, and access rules.

The second venue type is associated with investment firms (brokers) providing discretionary execution services OTC (not on formal markets) to their clients. Where execution services of this type are provided, orders from clients are executed by brokers against their proprietary (own) order books or 'crossed' against other client orders, and are not routed by the broker to an exchange or other platform. OTC bilateral trading between brokers and clients has long been a feature of equity markets in the EU and internationally.[44] Technological developments have, however, led to the development of automated broker execution services, particularly systems which provide execution by 'crossing' client orders. Broker execution is typically regarded as a client-facing service (thus, not a platform), which arises from the traditional fiduciary duties imposed on investment firms with respect to their clients, and from the related best execution obligations.[45] It is therefore functionally different to multilateral platform trading. As an investment service, it is typically regulated through conduct of business regulation.[46]

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[44] Eg IOSCO, (2011), *supra* note [*]. 4.

[45] Eg, Deutsche Bank, Response to CESR/10-394, emphasizing that investment firms provide discretionary bespoke trading/order management services on a confidential basis for clients in fulfilment of their fiduciary duties, and reflecting the historic obligation to obtain the best execution result for the client.

MiFID was designed to promote competition between these different trading venues in the interests of innovation, price competition, and investor choice, and to support the transparency and efficiency of the competitive trading marketplace. But once order execution moves away from the main exchanges and disperses across different venues, a series of risks arise.[47] Chief among them are (i) a fragmentation of liquidity into different pools, and a consequent diminution of the efficiency of the price formation process[48] and of the ability of brokers to deliver best execution; and (ii) conflict of interest risk for investors, where investor orders are executed OTC by the broker.[49] These risks are typically addressed through (i) transparency rules, which tie together different liquidity pools and, to different degrees, expose trading interests on competing venues; and (ii) best execution rules, which require brokers to discover, and direct orders to, the liquidity pool which delivers the 'best' result for the investor. But in choosing remedial rules, the legislator must make a determination as to the particular functionality of the order execution venue and the intensity and nature of the risks it carries.

Transparency rules are the main concern of this discussion, and of the MiFID Review, as they are acutely sensitive to different venues/trading functionalities. The focus is on pre-trade transparency as post-trade transparency rules apply to all trading venues in the EU (section 2.2). In principle, 'lighting' pre-trade equity orders carries risks. From the investor's perspective, pre-trade transparency rules carry market impact risks, particularly for large orders, as the market may move against the order as it is executed (a large sell order may drive the market down). From the venue perspective, multilateral discretionary trading platforms do not carry direct risk from pre-trade transparency, as platforms facilitate the interaction of different orders and do not trade directly. They would, however, face the risk of a loss of business were they not able to provide some degree of dark trading to meet investor needs, particularly with respect to

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46 CESR has distinguished between the client-oriented conduct of business rules which apply to investment firm/OTC execution services, and the market-oriented rules which apply to organized platforms: CESR/10-394, *supra* note [*], 27.

47 Eg Macey and O'Hara, 'From Markets to Venues: Securities Regulation in an Evolving World' (2005) 58 *Cornell Law Review* 563 and Petralla (2010) *supra* note [*].

48 On fragmentation risks pre-MiFID see Davies at al , *supra* note [*], 163.

49 See generally Gadinis, *supra* note [*], 323-331.

large orders. Trading platforms typically, however, benefit from waivers to transparency rules and can offer dark trading. OTC, bilateral venues face sharper risks. Where firms execute client orders against their proprietary instruments or capital, they then become subject to market impact risk as their trading position is exposed to the market and their capital is at risk. Firms' trading positions could, systematically, be undermined and it could become uneconomic to offer trading services. Accordingly, OTC venues are typically dark in order to protect these venues and support investor choice.

Bright-line distinctions between predominantly lit multilateral non-discretionary trading platforms, and predominantly dark bilateral discretionary OTC trading venues, are not, however, easily made in practice. Given the value of dark trading (discussed in section 3), competition and arbitrage risks can be significant, particularly where trading functionalities cross different regulatory classifications. Questions as to the appropriate volume of dark trading can also arise, particularly in the OTC segment. Transparency is a public good which feeds into the price formation process for all equity trading; as one market participant has noted 'every one likes transparent markets but nobody likes to contribute.'[50] In particular, the volume of dark trading carried out where OTC bilateral systems are automated can have implications for price formation.

2.2 *The MiFID Classification System*

MiFID I's regulatory model for addressing these complex questions is a compromise which reflects difficult political and institutional negotiations, and sharp conflicts between the incumbent exchange and the emergent investment firm/brokerage lobbies.[51] The four-level classification regime therefore reflects the fraught negotiation process,[52] rather than a coherent expression of order execution regulation.

First, the highest level of regulation applies to multilateral non-discretionary trading venues which bring together multiple third party buying and selling interests in accordance with non-discretionary rules, and which take the form of 'regulated markets'

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[50] European Parliament, ECON Committee, Trading in Financial Instruments – Dark Pools. Workshop Summary, 2010 (the Dark Pool Workshop), Deutsche Börse presentation.

[51] Ferrarini and Recine, *supra* note [*].

[52] Ibid.

(RMs).[53] In practice, this classification captures the incumbent, leading stock exchanges. RMs are subject to authorization requirements, including the initial and ongoing 'fit and proper' rules imposed on RM management and on the assessment of the RM's owners (Articles 36-38). Organizational rules apply (Article 39), including with respect to conflicts of interest management, risk management, the adoption of trading rules and financial resources, as do obligations with respect to market monitoring (Article 43). RMs are subject to detailed pre-trade and post-trade trading transparency rules, although Member States can apply waivers (Articles 44 and 45).[54] The classification is something of a muddle in that it blurs the trading functionality of RMs with the different functionalities, and investor protection concerns, which apply to their admission to trading and other issuer-facing functionalities.[55] RMs are distinguished from other multilateral, non-discretionary trading platforms by the distinct regime which applies to the admission of securities to trading on a RM (Article 40) and by extensive issuer disclosure obligations[56] and market abuse rules.[57] The RM designation thus represents an unhappy combination of two functionalities; multilateral trading, and issuer-facing admission of securities to trading. This matters because there is no real difference between the trading functionalities provided by RMs and the second class of venue (multilateral trading facilities or MTFs), discussed *infra* - but the trading regulatory regime is not uniform.

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[53] A regulated market is a multi-lateral facility operated and/or managed by a market operator, which brings together or facilities the bringing together of multiple third-party buying and selling interests in financial instruments - in the system and in accordance with its non-discretionary rules – in a way that results in a contract, in respect of the financial instruments admitted to trading under its rules and/or systems, and which is authorized and functions regularly and in accordance with the RM provisions under MiFID (Art. 4(1)(14)).

[54] The waiver regime applies at the discretion of the relevant Member States and provides for specific waivers, including for 'large in scale' trades, reference price systems, negotiated trades, and order management systems (Level 2 Regulation, Arts. 18-20).

[55] Or the rules and functionalities which apply to companies issuing securities to raise capital, and seeking to admit those securities on a trading venue.

[56] Under the Prospectus and Transparency Directives.

[57] Under the Market Abuse Directive.

Second, multilateral platforms, which bring together multiple third-party buying and selling interests in accordance with non-discretionary rules, but which do not opt for RM status, are designated as MTFs.[58] The MTF classification is thus MiFID's attempt to capture the distinct trading functionality which distinguishes organized platforms from the OTC markets. An MTF investment service may be provided by a market operator (in effect, an RM operator) or by an investment firm. Where provided by a firm, the service is subject to the investment firm regime, albeit with calibration reflecting the multilateral trading functionality. Thus, the operation of an MTF by an investment firm requires authorization under MiFID. The range of authorization, conduct of business and prudential rules which apply to investment services apply (Articles 5-13, 16-18, and 25). Conduct of business rules, however, are specifically excluded (Article 14(3)). Market operators are also permitted to operate MTFs, subject to verification of their compliance with MiFID's conditions for investment firm authorization (Article 5(2)). MTF operators, whether investment firms or market operators, are also subject to rules governing the trading process (Article 14) and the monitoring of compliance with the MTF's rules (Article 26). The same pre and post trade transparency rules as apply to RMs apply to MTFs with respect to equities admitted to trading on a RM.

Important differences apply to RM and MTF regulation, however, despite the identical trading functionality. An RM is individually authorized on compliance with MiFID rules governing RM systems and the RM market operator (Article 36). Multiple MTFs, however, can be operated by an investment firm or market operator once the investment firm obtains the necessary authorization to operate an MTF or the operator complies with the relevant MiFID conditions. Each RM (and RM rule-book) must accordingly be individually authorized, whereas several MTFs can be operated under a single investment firm or market operator authorization. With respect to ongoing regulation, the proportionality principle which applies to MiFID's prudential/organization

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[58] An MTF is a multi-lateral facility operated by an investment firm or market operator, which brings together multiple third-party buying and selling interests in financial instruments - in the system and in accordance with its non-discretionary rules – in a way that results in a contract and in accordance with the rules which apply to investment firms under MiFID (Art. 4(1)(15)).

requirements for investment firms operating MTFs (Article 14) does not apply to the equivalent RM regime (Article 39).[59]

The third category is a subset of the final and default category of OTC trading. It covers Systematic Internalizers (SIs), or investment firms which execute client orders OTC against their proprietary order books, but on a systematic basis. The classification is not related to trading volume. An SI is a firm which, on an 'organized, frequent, and systematic basis' deals on own account by executing client orders outside a RM or MTF (Article 4(1)(7)).[60] SIs are treated as investment firms, and so, unlike RMs/MTFs, are subject to a range of conduct of business rules governing the decision to internalize a client order. But, like RMs/MTFs, they are additionally subject to a transparency regime governing equities admitted to a RM, although this regime is highly complex and calibrated to reflect the risks to the SI of pre-trade transparency (Articles 22(2) and Article 27). Like all investment firms and MTFs/RMs, SIs are also subject to post-trade transparency requirements covering RM-admitted equities (Article 28).

Finally, OTC trading is the default venue for all other forms of execution. MiFID does not, however, address OTC venues directly. Recital 53 broadly describes the characteristics of OTC trades as trades which are ad hoc and irregular and carried out with wholesale counterparties, and which are part of a business relationship which is itself characterized by dealings above the 'standard market size' (the 'SMS' list for equities is maintained by ESMA) and where the deals are carried out outside the systems usually used by the firms concerned for SI business. Investment firms engaging in this activity are subject to MiFID's standard range of investment firm conduct of business rules on the execution process. Pre-trade transparency rules do not, however, apply and so the non-SI, OTC markets are dark pre-trade. Significantly, however, MiFID established, for the first time in some Member States, that post-trade transparency disclosure be made for all trades by investment firms with respect to RM-admitted equities (Article 28).

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[59] CESR/10-394, *supra* note [*], 25-26.

[60] The order execution activity must have a material commercial role for the firm and be carried out in accordance with non-discretionary rules and procedures, the activity must be carried out by personnel or systems assigned to that activity; and the activity must be available to clients on a regular or continuous basis (Level 2 Regulation, Art. 21).

This classification and transparency regime is supported by a data publication[61] and consolidation[62] regime, as well as by a best execution obligation imposed on investment firms executing client orders. The best execution regime is based on a flexible, process-based best execution concept which is designed to support competition between trading venues, in that RMs, MTFs, and internalizing firms can compete on price and also on the other aspects of trading.[63]

The following section examines the structural market change which followed MiFID I, which interest groups have gained, and whether/how this market change can be related to MiFID's core classification decisions.

3. MiFID's Impact

3.1 *Market Restructuring*

One year on, the major impact of MiFID I was becoming clear: MTFs were garnering an increased share of equity trading from RMs and OTC venues. In November 2008, the Commission reported that the MTF share of equity trading represented 11% of all EU activity.[64] Particular MTFs showed strong growth. Chi-X (established in March 2007)

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[61] RMs and MTFs must make their transparency data public on reasonable commercial terms and on a continuous basis during normal trading hors (pre-trade) and as close to real time as possible (post trade): Arts. 44 and 45 (RMs) and Arts. 29 and 30 (MTFs). SIs are required to make their pre-trade quotes available to the public in a manner which is easily accessible to other market participants on a reasonable commercial basis (Art. 27(2)), and all investment firms are required to make their post-trade transparency data available to the public as close to real time as possible, on a reasonable commercial basis, and in a manner which is easily accessible to other market participants (Art. 28(1)).

The level 2 Regulation specifies that data can be published through a RM or MTF, a third party, or through proprietary arrangements (Art. 30), subject to requirements with respect to reliability, monitoring, correction, consolidation, and availability to the public on a non-discriminatory commercial basis at a reasonable cost (Art. 32). The extent to which disclosure can be delayed is also regulated.

[62] CESR adopted level 3 guidance on the publication and consolidation of MiFID transparency disclosures (CESR/07-043), but it has not been effective.

[63] Ferrarini, 'Best execution and competition between trading venues: MiFID's likely impact' 2 *Capital Markets Law Journal* (2009) 404, arguing that a narrower best execution concept would have enhanced the market power of the incumbent exchanges, which have the deepest liquidity pools and generally offer the narrowest spreads (at 407).

[64] Commission, Emerging Trends in the European Equity Market (2008) (Emerging Trends), 2.

had increased its turnover from 0.65% in November 2007 to 5.3% in September 2008.[65] Much attention focused on Project Turquoise, an MTF joint venture (then) between a group of investment firms,[66] which attracted 0.93% of activity in its first month of operation (August 2008).[67] MTF competition was particularly marked in the UK. The Chi-X share of FTSE turnover was 21.3%, while the London Stock Exchange's market share was down from 70% to 60%.[68] MTFs were also taking market share from the OTC sector; OTC trades in FTSE shares reduced from 25% to 20% in 2008.[69] Across the EU, FESE reported in 2008 that 11 new MTFs were competing for pan-EU equity trading.[70] MTF trading was, however, selective, with MTF trading tending to focus on the most liquid shares.[71] Nonetheless, the incumbent exchanges (typically RMs) remained dominant, representing 75% of turnover.[72] But the exchanges' market share reflected the relevant domestic market, being based on domestic shares for the most part;[73] they were not attracting cross-border share trading. Reflecting earlier predictions, SI activity seemed limited, with only 11 major investment banks registered as SIs.[74] With greater competition, difficulties were emerging with data quality. Liquidity fragmentation was

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65 Ibid, 2 and 4.

66 It is now part owned by the London Stock Exchange and a group of investment banks.

67 Emerging Trends, *supra* note [*], 2.

68 *Ibid.*

69 Emerging Trends, *supra* note [*], 2 and 4.

70 FESE (November 2008), *supra* note [*].

71 Emerging Trends, *supra* note [*], 2 and 7.

72 Emerging Trends, *supra* note [*], 4 and 5.

73 Emerging Trends, *supra* note [*], 5. The London Stock Exchange Group, eg, had 60% of the UK share trading market, but 20% of EU share trading. Deutsche Börse had 60% of German share trading, but 16% of EU share trading.

74 Eg FESE (November 2008), *supra* note [*].

also occurring, although there was little evidence then as to whether this was prejudicing equity price formation.[75] Greater competition also drove an early drop in trading fees.[76]

The major changes to market structure began to take place in 2009.[77] CESR's important 2009 report on the equity markets[78] found that RMs remained dominant,[79] but were generally trading domestic shares and were not providing extensive pan-EU trading in shares admitted to RMs elsewhere. CESR also emphasized the continuing importance of RM prices as references for the equity market, highlighting that when the London Stock Exchange closed briefly on September 2008, trading did not switch to MTFs.[80] RMs were, however, responding to competition. The pre-MiFID exchange consolidation trend,[81] driven by a search for economies of scale and critical mass, had continued,[82] strengthening the position of the major RMs. Investments in RM trading technology were made. Sponsored access[83] and co-location[84] facilities were developed to support high frequency trading.[85] Initially, the major RMs also developed trading models designed to meet competition from SIs,[86] but the focus quickly turned to MTFs, and particularly to

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75 Chi X Presentation, Commission MiFID One Year on Conference November 2008, noting that Chi-X had 22.74% of FTSE 100 share trading in October 2008; FESE (November 2008), *supra* note [*], showing the fragmentation of liquidity between RMs and MTFs.

76 Emerging Trends, *supra* note [*], 2.

77 Lannoo and Valiente, The MiFID Metamophosis. ECMI Policy Brief 16 (2010), 1.

78 *Supra* note [*].

79 The four main markets by value of equity trading as at March 2009 were the LSE (London Stock Exchange Group) (the largest), Euronext, Deutsche Börse, and the Spanish markets: *ibid*, 6.

80 *Ibid*, 10.

81 Eg, Moloney *supra* note [*], 854-856.

82 Eg, the London Stock Exchange/Borsa Italiana merger (pre-MiFID) and the Vienna/Prague Stock exchange merger (post-MiFID): *ibid*, 9.

83 Under 'sponsored access' a market participant, in certain circumstances, can, to enhance trading speed, give their clients direct connectivity to the market's order book in the name of the participant.

84 'Co-location' refers to the ability of venue participants and clients to situate their trading facilities very close to the venue's central matching engine and thereby gain additional (albeit measured in nano-seconds) trading speed.

85 See further *infra.*

dark MTFs. The importance of dark trading as an instrument of competition was by then becoming clear, as was the market-shaping effect of MiFID's pre-trade transparency waivers for RMs/MTFs, with the new MTFs operated by RMs including 'dark pool' MTFs.[87]

The major developments were, accordingly, in the MTF sector. Although a number of MTFs were in operation pre-MiFID (including Virt-X, Chi-X, ITG Posit, Liquid Net and a number of German trading systems[88]), CESR reported that the sector experienced significant growth post-MiFID.[89] By June 2009, 24 MTFs were operating; 10 of these were established around the time of MiFID coming into force.[90] Both RM market operators and investment firms were operating MTFs.[91] CESR reported that MTFs were designed to compete with primary RMs for trading in domestic equities and also to provide trading facilities in a range of liquid, pan-European shares.[92] They tended to invest heavily in trading technology and to provide dark and lit trading functionalities.[93] Like the RMs, MTFs were engaging in price competition, offering lower fees, and using fees to attract liquidity. Despite rapid growth, MTFs were not, however, seriously challenging the dominance of RMs, although Chi-X had quickly established

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86 Including the London Stock Exchange (a market-making driven scheme designed to encourage liquidity at greater sizes and tighter spreads), Deutsche Börse (Xetra Best), and Euronext (an internal matching system designed to allow members to optimise the execution of orders against proprietary and client orders in the central order book) .

87 Eg, Euronext's dark pool (Smartpool), and the London Stock Exchange's Baikal. Similarly, Lannoo and Valiente (2010), *supra* note [*], 2, noting the move across major exchanges to build dark and lit MTFs in response to competitive pressures.

88 There was a long tradition of German RMs operating MTFs for share trading. CESR reported that 8 MTFs operated under German regional exchanges in 2009): June 2009 *supra* note [*], 11 and 13-14.

89 Also Gomber and Gsell (2011), *supra* note [*], 105-109.

90 BATS Trading, Black Board (Pipeline), Burgundy, Euro Millennium (NYFIX), Instinet BlockMatch, MTFPEX, NASDAQ OMX Europe, NYSE ARCA Europe, Smartpool and Turquoise.

91 Eg, SmartPool and NYSE Arca Europe, operated by NYSE Euronext, and Chi-X and Turquoise, originally operated by investment firms.

92 Eg, Chi X Europe (established pre-MiFID) covered 14 European market segments, BATS Trading (established in November 2008) covered 11 European market segments, and Smartpool (established in February 2009) covered 15 European market segments.

93 Turquoise, eg, provided dark and lit trading functionalities, with dark trading representing 10% of its business: Dark Pool Workshop, *supra* note [*], Turquoise presentation.

itself as a major competitor. In March 2009, Chi-X had 62% of total MTF turnover, followed by Turquoise (25%), BATS Europe (9%), EuroTLX (3%) and NASDAQ OMX Europe (1%). Similarly, a CEPS study reported that by end 2009 new entrants had garnered some 20% of total equity trading in the EU and noted a shrinkage in the London Stock Exchange's share of trading from 35% to 24% over 2007-2008.[94] Overall, equity trading in 2009 was split between the London Stock Exchange Group (23.9%), Euronext (17.9%), and Deutsche Borse (13%), and MTFs including Chi-X (12.5%), Nasdaq OMC (6.8%), Turquoise (3.9%), and BATS Europe (2.6%).[95]

In terms of OTC trading, SI activity remained limited, with CESR reporting that only 11 investment firms were registered as SIs, six of these being registered with the UK FSA,[96] and suggesting that it had proved a less attractive business model than had seemed likely.[97] CESR noted, however, the emergence of the investment firm BCSs which have since come to dominate the MiFID Review, and related concern from the MTF/RM sector.[98]

In terms of overall market impact, CESR reported the industry view that execution costs had reduced, but that the costs of trading were higher given the fragmentation of liquidity. CESR also reported market concern with respect to a widening of spreads (or the difference between buy and sell prices),[99] although the evidence on this point is contradictory, as noted *infra*. CESR also highlighted the poor quality of OTC post-trade data in particular, which was hindering the development of effective data streams.[100] The 2009 CFA Report,[101] however, found that while

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94 Lannoo and Valiente (2010), *supra* note [*], 1.

95 Lannoo and Valiente (2010), *supra* note [*], 2.

96 CESR June 2009, *supra* note [*], 16; SIs were also registered in Denmark and in France.

97 CESR June 2009, *supra* note [*], 30.

98 CESR June 2009, *supra* note [*].

99 CESR June 2009, *supra* note [*], 18.

100 CESR June 2009, *supra* note [*], 26-27. The 2010 CEPS Report (*supra* note [*]) reported similar market concerns.

101 Centre for Financial Market Integrity, Market Microstructure (2009) (CFA Report).

fragmentation was occurring, there was no evidence that it was detrimental to the quality of price formation.

It also became clear that post-MiFID competition and fragmentation was generating arbitrage opportunities which supported the rapid growth of algorithmic and in particular high frequency trading (HFT). HFT is a latency (speed)-based form of algorithmic trading (or automated trading based on sophisticated computer technology which dictates trading decisions and which takes advantage of arbitrage opportunities). HFT, which is growing rapidly in the EU,[102] can bring significant benefits to markets in the form of deeper liquidity, reduced spreads, and better price alignment across venues. But risks can be generated, particularly where HFT traders withdraw in volatile market conditions[103] and where HFT failures threaten orderly trading, as suggested by the 'Flash Crash' on US exchanges on May 6 2010. Doubts have also been raised as to whether real liquidity benefits are created, in that HFT tends to lead to a decrease in trade order size, rather than to new liquidity. In 2010, CESR noted that the average trade size on the London Stock Exchange in 2009 was €11, 608, down from €22, 266 in 2006. HFT is also associated with poor quality liquidity, volatility and churning.[104]

By 2010, and as the opposing lines of the upcoming MiFID Review were becoming clear, attention focused more closely on the emerging main line of controversy: the scale of lit (predominantly MTF/RM) and dark (predominantly OTC) trading. CESR's April 2010 consultation on the equity markets focused closely on the scale of dark and lit trading in the OTC and non-OTC space. It reported that 90% of trading on RM/MTF venues was pre-trade transparent (lit).[105] CESR provided little data on OTC trading although it did address the scale of OTC trading through BCSs,[106] which it found

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[102] It is estimated to be in the region of 30-50% of trading: FSA, *supra* note [*], 18.

[103] Eg Grob (2011), *supra* note [*], 151.

[104] Hertig (2010), *supra* note [*].

[105] Average 8.9% per quarter in 2009: CESR/10-394, *supra* note [*], 6. In Q1 2010, this was down to 8.5%, although up from Q1 2009 (7.6%): CESR/10-802, *supra* note [*], 8.

[106] Based on data provided by 11 investment firms and the Thomson Reuters database.

represented some 1.15% of total EEA trading in 2009 (up from 0.7% in 2008).[107] The trend is unclear; the 2009 quarter 4 average was 4%, but the 2010 quarter 1 average dropped to 1.5%.[108] But it not unreasonable to describe these volumes, as one report has suggested, as 'systemically irrelevant'.[109] A CESR presentation similarly suggested that the volume of BCS trading is 'still quite low.'[110] The 2010 Celent Report, however, highlighted that BCS volumes represented a significant 19% of the overall dark pool market, including RM/MTF dark pools.[111]

The 2010 CESR Consultation did not contain a figure for the heavily contested volume of overall OTC trading,[112] which figure has become of central importance in the debate as to whether 'too much' trading is occurring OTC and is dark. The difficulties in collating OTC data are considerable, given multiple reporting of single OTC transactions.[113] In summer 2010, however, the European Parliament held a workshop on dark pools which collated additional data,[114] including CESR's important finding that total OTC trading represented 30-40% of total EEA equity trading.[115] The 2010 European Parliament Resolution similarly suggested that 39% of all reported trades were OTC.[116]

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107 CESR/10-394, *supra* note [*], 27.

108 CESR/10-394, *supra* note [*], 34.

109 Lannoo and Valiente (2010), *supra* note [*], 3.

110 European Parliament Dark Pool Report, *supra* note [*], CESR Presentation.

111 *Supra* note [*]. The report found that nearly every second OTC trade in the test period in high liquidity shares was below standard market size (6 of 10 trades in less liquid shares). For a summary see Gomber/Pierron (Celent), Response to Commission Consultation.

112 Leading FESE to an attempt to reconstruct the OTC future from the data which CESR disclosed. It estimated accordingly that 38% of total trading was OTC: FESE, Statement on the CESR Consultation Paper on Equity Markets (2010).

113 CESR's controversial data on the scale of crossing network trading, eg, may be inflated due to difficulties of ascertaining OTC trade volume accurately given the potential for multiple reporting of a single OTC transaction: CESR/10-394, *supra* note [*], 27 and European Parliament Dark Pool Workshop, *supra* note [*], 12. Similarly, noting that difficulties with gathering OTC data, FESE, Statement on Equity Market Data (2010).

114 European Parliament Dark Pool Workshop, *supra* note [*].

115 European Parliament Dark Pool Workshop, *supra* note [*], CESR presentation, 16.

116 European Parliament Resolution, *supra* note [*], para H, citing CESR.

Similar data was provided by Deutsche Börse (based on FESE data), which suggested that in 2009 47% of equity trading took place on RMs and 9% on MTFs (with an additional 6% on RM/MTF dark pools), 2% by SIs, and 36% OTC.[117] The OTC markets were also considered in the important 2010 Celent Report which, *inter alia*, reported that a significant proportion of dark trades in the OTC market were, notwithstanding MiFID recital 53, small and would not ordinarily generate market impact risk.[118]

Overall, and some four years on, equity market trading is clearly fragmented across a range of dark and lit venues, many of which are new.[119] The Commission's 2011 MiFID Impact Assessment indentifies 231 trading systems in the EU equity trading market, including 132 MTFs, 92 RMs, and 12 SIs.[120] In the UK, for example, equity trading takes placed on 7 organized platforms (RMs and MTFs): the London Stock Exchange, Chi-X, Turquoise, BATS Europe, NASDAQ OMX, NYSE Arca and the Plus Markets. In Germany, some 25% of trading in DAX 30 stocks takes place outside Deutsche Börse, while in France, some 30% of trading in CAC 40 stocks takes place outside Euronext.[121] But the extent to which fragmentation is occurring is contested, given that many new venues rely on reference prices from leading RMs[122] and given the dominance in practice of the incumbent RM in many Member States.[123]

Although RMs remain dominant, MTF market share is increasing, with the largest MTFs accounting for 23% of equity trading at January 2011.[124] In terms of dark and lit

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[117] European Parliament Dark Pool Workshop, *supra* note [*], Deutsche Börse Presentation.

[118] The report found that some 48% of OTC trades in liquid shares were below 'standard market size', and some 58% of those trades in less liquid shares: at 18 and 23. The Report concluded that 'most OTC trades, if analyzed on a trade by trade basis, are rather small and would not face market impact' (at 28).

[119] Eg Grob *supra* note [*],, 127. Similarly Gresse, Multi Marketing Making and Market Quality (2010).

[120] Impact Assessment, *supra* note [*], 88.

[121] FSA, *supra* note [*], 15.

[122] Gomber and Gsell (2011), *supra* note [*], 116.

[123] Gresse, *supra* note [*], finding that only 14% of 'on market' trading volume in the sample occurred away from the primary exchange.

[124] Chi-X, BATS Europe, and Turquoise: Impact Assessment, *supra* note [*], 88.

trading, MTF/RM trading (some 60-70% of total trading) is predominantly (90%) lit.[125] FESE figures for 2009 similarly suggest that 47% of EU equity trading is in the form of lit RM trading and 9% is in the form of lit MTF trading.[126] FESE has also suggested, based on 2009 trading, that 43.4% of total trading is dark, composed of dark RM/MTF trading (5.6%), crossing networks (1.2%), and other OTC trading (37.8%).[127] The number of dark pools operated by RMs/MTFs under MiFID waivers has increased,[128] and most major EU stocks are now traded across 9 dark venues, as compared to 3 in 2008.[129] New MTFs have been particularly successful in garnering market share in dark trading, with the formal dark market increasing from 3 to 12 venues over 2008-2010 and dominated by two new entrants (Chi-Delta and Turquoise Dark).[130] There is some evidence, however, that the volume of MTF dark trading may be stabilizing.[131]

A significant minority of trading - 30-40% - is OTC.[132] This figure is, however, heavily contested between the exchange lobby (which is seeking to apply the MiFID classifications to a larger proportion of OTC trading) and the OTC sector. FESE, for example, has repeatedly called for a close examination of the scale of OTC trading, suggesting that it is in the region of 30-40 %, and argued that the scale of OTC trading does not fit MiFID's assumption (per FESE) that OTC trading is a residual category.[133]

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125 Gomber and Gsell, *supra* note [*].

126 FESE, Statement on the CESR Consultation Paper on Equity Markets, 12 May 2010. The Grob study suggested that 56.3% of non-OTC trading is lit (*supra* note [*], 43).

127 FESE, Statement on the CESR Consultation Paper on Equity Markets, 12 May 2010.

128 Grob refers to an 'exponential increase' since 2008: *supra* note [*], 158.

129 Grob, *supra* note [*], 156-7.

130 Ibid, 157.

131 Turquoise has noted that while volumes of dark trading initially increased on the platform, it has since stabilized at 10% of the platform's trading. European Parliament Dark Pool Workshop, *supra* note [*], Turquoise Presentation, 11.

132 CESR has relied on the 30-40% figure, while Celent has suggested the OTC markets represent 40% of trading turnover (*supra* note [*]). The Grob study also estimates the OTC sector at 40%: *supra* note [*], at 43. The 2011 CFA Report similarly suggests that 46.4% of all trading (including RM/MTF waiver trading) is dark (*supra* note [*]).

The OTC sector has argued that the real volume of OTC trading is smaller and called for a focus on OTC trading which represents 'executable liquidity'.[134] It does seem clear that most dark trading is occurring in the OTC space.[135] Dark trading OTC on BCSs, however, is limited, representing only 1.5% of total trading according to CESR, although some 19% of total dark pool trading.[136] Only a small proportion (some 2% of total trading, according to FESE[137]) of OTC trading is by SIs and so is partially lit; market interest in SI trading data also seems limited.[138] CESR has suggested that the overall volume of dark OTC trading has, however, remained stable post MiFID,[139] although evidence has been presented that the dark OTC sector is growing.[140] As the MiFID Review is showing (section 4), there is considerable concerns from some quarters as to the potential growth of the dark OTC sector.[141]

There is some evidence of market satisfaction with the pre-trade transparency regime, with one report suggesting that stakeholders have seen an improvement post-

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133 Responses to Commission Consultation, 2 February and 4 April 2011. FESE has suggested 36% (eg, FESE, Presentation to September 2010 Commission Public Hearing on the MiFID Review), but has noted that, depending on how trades are counted, it could be as low as 13%.

134 Eg, AFME, Response to Commission Consultation. AFME suggested that only 1/3 of the 40% of trading OTC represents 'real liquidity', in that much of OTC trading forms no part of the price formation process and so does not represent liquidity available to other market participants. It suggested that OTC markets more accurately represent 10% of trading. Much industry attention has focused on the TABB Group Report which suggested that less than a quarter of OTC reportable trades is executable and that 72% of executable liquidity is traded on the lit order books of RMs/MTFs: TABB Group, Breaking Down the UK Equity Market: Executable Liquidity, Dark Trading, high Frequency and Swaps (2011).

135 Grob, *supra* note [*], 142-143

136 Celent Report, *supra* note [*].

137 FESE, Presentation to September 2010 Commission Public Hearing on the MiFID Review. Similarly, Grob, *supra* note [*], 143 (1.69%).

138 Markit Boat, Response to CESR/20-394, reporting little user interest in the datasets related to the 8 SIs which reported through MarkitBoat.

139 Similarly, the Celent Report and the CFA 2011 Report (which suggested that between January 2008 and October 2010 there was significant up or down trends in the relative share of the lit RM/MTF and dark OTC sectors).

140 European Parliament Dark Pool Workshop, *supra* note [*],, Deutsche Börse Presentation.

141 European Banking Federation, Response to CESR/10-394, suggesting that the strong relative growth of the OTC markets at the expense of pre-trade transparent markets would be problematic, given the negative impact on price formation.

MiFID.[142] Some retail stakeholders, however, are concerned as to overall transparency levels, and have suggested that pre and post-trade transparency levels have reduced.[143] The retail sector has also raised concerns over dark OTC trading, with one stakeholder calling for the OTC markets to be restricted to less than 10% of overall trading volume.[144] Views also differ on whether the depth of liquidity is being prejudicially reduced by fragmentation. AFME and BBA, for example, while supportive of competition,[145] are of the view that liquidity is reducing.[146] There is some evidence that dark trading may be damaging liquidity.[147] MTFs also seems to be focusing on the most liquid shares, thereby pulling away liquidity from established RMs, rather than on creating new liquidity.[148] There is, however, some contested evidence that MTFs have attracted new liquidity from the OTC sector, benefiting price formation more generally.[149] There is also some evidence that retail market liquidity is deepening.[150]

There is also little consensus on the extent to which liquidity fragmentation is damaging price formation and/or influencing spreads.[151] The benefits from fragmentation

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[142] London Economics (2010) and (2011) (*supra* note [*]). Similarly, Bundesverband Deutscher Banker (German Banking Association), Response to CESR/2010-394, and AFME/BBA Response to CESR/10-394.

[143] Euroshareholders, Response to CESR/10-394 and Response to Commission Consultation, suggesting that retail investors miss 50-60% of data.

[144] Euroshareholders, Response to CESR/10-394.

[145] Eg AFME, Response to Commission Consultation.

[146] AFME/BBA, Response to CESR/10-394.

[147] Degryse et al (2011), n *supra* note [*], based on a sample of Dutch stocks; the study found that fragmentation of lit trading could increase liquidity.

[148] Celent Report, *supra* note [*],, 30.

[149] CESR June 2009, *supra* note [*], 12.

[150] London Economics (2011), *supra* note [*].

[151] The Gresse study (*supra* note [*]) suggests that fragmentation has affected price quality by increasing short term volatility. A study of Euronext trading, however, has suggested some improvements in market quality for liquid stocks: Soltani et al *supra* note [*]. A study of trading in UK blue chips has also suggested that a high fraction of trades are executed at best available prices: Storkenmaier and Wagener, Do we need a European 'National Market System'? Competition, Arbitrage, and Suboptimal Executions (2011), available at http://ssrn.com/abstract=1760778.

seem to be unevenly spread, with traders who trade across several venues benefiting from narrower spreads more than local traders on the primary market.[152] The impact on costs is also unclear. While trading costs reduced initially, they now seem to be increasing, although this may be related to wider market volatility and reduced trading levels.[153] Cost reductions seem to have been asymmetrically allocated, with liquidity providers benefiting but other traders, and particularly retail investors, not seeing a real reduction in trading costs.[154] The AFME and BBA have suggested that trading costs are increasing, while APCIMS has highlighted the extra costs in achieving best execution.[155]

Other micro-structural features include the growing importance of algorithmic and HFT trading and the related proliferation of small orders. By driving down average trade size, these forms of trading are placing pressure on large trades[156] and on the RM/MTF 'large in scale' waiver for dark trading.[157] They may therefore be driving a move towards dark OTC trading. The evidence as to the growth of small orders is contested, however, with some industry actors suggesting that it is not significantly reducing,[158] others noting that large/parent orders are routinely split,[159] others pointing to a 'dramatic' decline,[160] and others suggesting that insufficient evidence exists.[161] It does

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Stakeholder surveys have also been positive. Eg, London Economics (2011), *supra* note [*], reporting that the buy-side found price quality to have improved and price volatility to have increased, and CEPS, MiFID Review: What next for European Capital Markets (2010), suggesting that there was no evidence that fragmentation had damaged price formation.

152 Gresse *supra* note [*].

153 London Economics (2010), reporting a drop in trading costs between 2000-2001 and 2006-2007 but an increase over 2009: *supra* note [*].

154 Eg, APCIMS, Response to CESR/10-394, Euroshareholders, Response to Commission Consultation , and London Economics (2010), *supra* note [*].

155 APCIMS, Response to CESR/10-394.

156 FSA, *supra* note [*], 17.

157 CESR/10-394, noting industry concern that the growth of algorithmic trading and of small orders was placing pressure on the 'large in scale' waiver for RM/MTF trading.

158 AFME/BBA, Response to CESR/10-394.

159 Barclays Capital, Response to CESR/10-394.

160 European Banking Federation, Response to CESR/10-394.

appear to be the case that small trades are routinely being executed in the informal OTC space,[162] notwithstanding the recital 53 definition of OTC trades and the related MiFID presumption that small retail orders and standard marketable order flow should be executed in a MiFID-regulated venue.[163]

Consensus does exist as to the poor quality of post-trade information,[164] particularly with respect to the quality of OTC post-trade data. This is associated with the prevalence of reporting through proprietary OTC channels[165] and the poor quality of data which can be provided to commercial suppliers. But even here there is doubt, with some elements of the investment firm lobby emphasizing that a significant majority of trades are published within one minute and that reliance on post-trade waivers is limited.[166] Concerns are also common with respect to the poor consolidation of data generally.[167]

Overall, post-MiFID the marketplace has changed. Competition has led to greater fragmentation in the equity markets, technological developments such as HFT have influenced market microstructure, and the quality of transparency information has been weakened in some respects.[168] The extent to which legal reform is necessary, and the form which it should take is not, however, clear.

3.2 *Winners and Losers and MiFID's Role*

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161 ABI and EFAMA Responses to CESR/10-394. Similarly, Euroshareholders, Response to Commission Consultation, suggesting that there is no evidence that investor orders have decreased.

162 Celent Report, *supra* note [*].

163 Eg, WFE, Response to Commission Consultation and CFA Report (2011).

164 Eg the stakeholder surveys by London Economics and Valiente and Assi (*supra* notes [*]).

165 The Italian Banking Federation, eg, reported that a significant number of intermediaries reported through their own websites: IBF, Response to CESR/10-394.

166 AFME/BBA, Response to CESR/10-394, reporting that 80-93% of OTC trades reported through MarkitBoat are published within 1 minute and that some 20% of the 50% of OTC trades reported through MarkitBoat which are eligible to avail of deferred reporting do so, and that only 28% of this 20% are deferred to the end of the business day (based on turnover). MarkitBoat has also reported that 99% of trades are reported to it within 3 minutes: MarkitBoat, Response to CESR/10-394.

167 Eg European Securities and Markets Expert Group, Fact finding regarding the availability of post-trade data in equities in the EU (2009).

168 FSA, *supra* note [*], 4.

Even with hindsight, it is difficult to disaggregate the opportunities and incentives which MiFID I generated and which re-allocated trading market benefits from those produced by wider market developments. The latter include technological developments and the general crisis-era market instability which reduced venue revenues and spurred the search for competitive advantage.[169] The US experience under Regulation NMS has been similar.[170] But it seems clear that the abolition of the concentration rule created the conditions for multiple venues to develop[171] and led to greater volumes of pan-EU trading than would have occurred without MiFID I.[172]. Failure by some Member States to implement MiFID I fully also limited competition.[173] It also seems clear that MiFID created the conditions for venues to adapt their business models in order to compete for lucrative dark trading.[174] On the other hand, the extent to which legal change has reshuffled benefits market is not clear. The arrival of algorithmic and HFT trading, for example, has had significant impact on liquidity provision and reduced the size of trades, creating pressure for dark OTC trading as a protection against market impact.[175]

The incumbent RMs can be identified as winners and as benefiting from MiFID I. While they faced competitive challenge, they seem to have consolidated their position and to have benefited from incumbency, particularly with respect to liquidity.[176] The major MTFs – with the exception of Chi-X which is the third largest venue for equity

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169 Lannoo and Valiente (2010), *supra* note [*], 2.

170 The SEC has related the transformation of US equity trading to regulatory change and enforcement, but also to technological developments: SEC, *supra* note [*], 4.

171 Eg, Hertig, suggesting that 'the crucial driver happened to be MiFID's entry into force' (*supra* note [*], 1991) and Celent Report, finding the emergence of alternative trading venues to be a MiFID success (*supra* note [*], 31).

172 London Economics (2010), *supra* note [*].

173 Santander reported in November 2009, eg, that Spanish MTFs were not able to trade Spanish equities as the necessary changes had not been made to Spanish settlement systems: Santander Presentation, Commission MiFID One Year on Conference November 2008.

174 Eg, European Investors Working Group, Restoring Investor Confidence in European Capital Markets (2010).

175 London Economics (2010), *supra* note [*].

176 CESR June 2009, *supra* note [*], 6-7 and Gresse *supra* note [*].

trading by market share [177] - are not yet in a position to challenge the major RMs. Law has accordingly struggled to break down the advantage of major incumbent RMs with respect to lit trading. RM dominance may also have been strengthened by MiFID's best execution regime which, by focusing on best price as the benchmark for best execution in the retail sector, supports execution on RMs.[178] RMs have also responded strongly to the opportunities represented by MiFID, establishing specialized lit and dark MTFs.[179] MiFID may, however, have restricted the extent to which RMs can compete for dark trading, given the conditions which apply to the pre-trade transparency waivers which are essential for the development of RM/MTF dark pools.[180] It may, therefore, be the case that MiFID has prompted a drift towards OTC dark trading and away from RM/MTF dark trading as it is subject to MiFID restrictions.[181] MiFID-led fragmentation of liquidity may also have led to smaller trades, which place greater pressure on large orders, and, ultimately have created more demand for dark trading which can be more easily met OTC.[182] But the range of factors which may be leading to higher volumes of OTC trading makes it difficult to make a determinative link between MiFID's legal regime and a threat to RM/MTF trading, whether dark or lit.

The brokerage/OTC sector can also be regarded as a winner and has benefited from its ability to run dark and lit MTFs under MiFID. Under MiFID I, brokers can operate MTFs without changing their business model from investment firm to market operator. By November 2008, 4 lit and 5 dark MTF platforms were already operated by investment firms.[183] The sector has garnered other benefits from MiFID I. Some of these might, however, be regarded as arising from the sector's ability to 'game' MiFID. For

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177 Impact Assessment, *supra* note [*], 89.

178 Ferrarini, *supra* note [*], 409-410.

179 FESE November 2008, *supra* note [*].

180 As has been argued by the RM/MTF sector: CESR/10-975.

181 European Parliament Resolution, *supra* note [*]. Similarly, London Economics (2010), suggesting some stakeholder (broker) support for this position (*supra* note [*]).

182 European Parliament Resolution, *supra* note [*].

183 BATS, Burgundy, Chi-X, and Turquoise (lit); Liquidnet, NYFIX Euro Millennium, Pipeline, Posit, and Turquoise (dark): FESE November 2008, *supra* note [*].

example, SI activity, which pre-MiFID was not subject to discrete transparency regulation, might have been expected to suffer, given the new costs.[184] But firms have been able to turn the legal regime to their own advantage while reaping the benefits of SI activity.[185] The requirement that the SI regime apply only to 'non-discretionary' SI systems, for example, has been interpreted by some firms as taking their internalization systems outside the SI regime, given the initially discretionary decision by firms as to where to place the client order. It also seems clear that brokers have been able to carry out considerable trading in the lightly-regulated OTC classification. The Recital 53 definition for OTC trades, which refers to 'ad hoc and irregular' trades, is not restricting investment firms in operating BCSs within MiFID's OTC classification.[186] Neither is the reference in recital 53 to OTC trades 'which are part of a business relationship which is itself characterized by dealings about the standard market size' preventing the execution OTC of small orders which, recital 53 suggests, should not be systematically executed OTC.[187] The reliance on 'non-discretionary trading' as a determining characteristic of an MTF under MiFID I has also provided legal support for the development of automated non-MTF systems in the OTC space, which are discretionary in that the firm restricts access to its clients.[188] Finally, although the SI regime applies to the systematic crossing of client orders against a firm's proprietary inventory, this does not seem to have prevented the OTC sector from operating BCSs which cross against proprietary orders, but which are not regulated as SIs.[189] There is also some (contested[190]) evidence that OTC brokerage firms have optimized the different deferral opportunities under MiFID I's post-trade transparency regime, with CESR reporting that some firms were systematically

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184 Gomber and Gsell, *supra* note [*].

185 Internalisation allows firms to earn spread-related profits, exploit informational advantages, and offer enhanced services, notably price improvement, to clients: Gomber and Gsell, *supra* note [*].

186 See also Gomber/Pierron (Celent), Response to Commission Consultation.

187 Celent Report, *supra* note [*].

188 AFME/BBA, Response to CESR/10-394.

189 Leading the EBF to call for better enforcement: EBF, Response to CESR/10-394.

190 *Supra* note [*].

relying on the maximum 3 minute reporting time available for post-trade reporting.[191] More generally, as the post-trade transparency regime is lighter post-MiFID in some Member States than pre-MiFID,[192] the increased trading opportunities for OTC firms post-MiFID may have not been matched by a more demanding post-trade regime.

The buy-side/investor picture is muddy. Institutional investors seem to have benefited from MiFID I's support of dark pools through the RM/MTF waiver regime and OTC trading.[193] MTFs, in particular, have a track record of providing price improvement and managing market impact costs.[194] RMs and MTFs have also introduced liquidity-sensitive trading fees which have benefited the institutional community.[195] More venues are also now available for managing large orders, which is a major concern for institutional investors. On the other hand, poor data quality is a concern.[196]

Retail investors, by contrast, do not appear to have benefited from legal change under MiFID, although the retail markets were a recurring concern of the MiFID negotiations,[197] with the contested SI regime associated with a concern in some Member States, particularly Italy, to protect the retail sector.[198] But retail investors appear to have fared less well as direct traders (they have benefited indirectly as holders of collective investments). Trading cost reductions have not generally been passed on, given the increased costs of best execution for smaller retail brokers.[199] MiFID does not appear to

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[191] CESR 2010/10-394.

[192] Previously, some Member States required that OTC trades were reported to an exchange. The MiFID post-trade delay regime is also more generous than some earlier Member State regimes: CESR 2010/10-394, 15-16.

[193] Eg ABI, Response to CESR/10-394, underlining the importance of competition.

[194] Liquidnet, eg, noted in its US SEC returns that it had achieved 95.05% price improvement for customer orders over the reporting period: Liquidnet, Response to Commission Consultation.

[195] CESR June 2009, *supra* note [*], 18.

[196] Eg, CFA Report, *supra* note [*], and ABI, Response to CESR/10-394.

[197] Moloney, How to Protect Investors (CUP, 2010), 345-350.

[198] Deutsche Bank has suggested that: 'The retail protection driver has prevailed to the extent that it has made public trading venues accessible to retail size trades to the detriment of the execution of larger wholesale orders'. Response to CESR/10-394.

have increased the number of retail-driven venues.[200] Even allowing for the necessity for the retail investor lobby to over-emphasize to make a point given the weight of industry opinion, significant concern as to the limited benefits to the retail sector has been expressed by major retail stakeholders.[201]

From an institutional perspective, CESR (now ESMA) has emerged as the EU actor with the strongest grasp of empirical realities and the closest connection to the industry. It struggled to achieve supervisory convergence on the application of the MiFID I pre-trade waiver regime for RMs/MTFs (noted *infra*). But it has left a clear imprint on the MiFID Review. Its 2009 own initiative report on equity trading was a shrewd move, placing CESR at the heart of the subsequent debate. As noted in section 4, its 2010 Advice was generally well-received and has cast ESMA as in tune with market interests. The MiFID II proposals also envisage a key role for ESMA in the reform of trading market regulation. The Commission has been less sure-footed (section 4). The Parliament, energized after a series of successful engagements with ECOFIN on the post-crisis legislative reform agenda, has emerged as a force to be reckoned with, adopting a 2010 own initiative Resolution which highlights Parliamentary concern over the OTC markets and an extensive summer 2010 workshop on dark pools (section 4).

Member State reaction is not entirely clear. Member States have different positions on whether equity trading should be moved to formal lit venues; this might suggest concern in some Member States as to a loss of business post-MiFID to the OTC sector. Efforts through (then) CESR to establish consensus positions on the granting of MTF/RM pre-trade transparency waivers for dark trading[202] have struggled in some cases, with a qualified majority vote (rather than the usual consensus) being required for some applications and, in one case, CESR being unable to reach the QMV threshold. France, Italy, and Greece have been less willing to grant waivers, citing risks to prejudice

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199 CESR 2009, *supra* note [*], 18; APCIMS, Response to CESR/10-394.

200 Citigroup Global Markets Ltd, Response to CESR/10-394.

201 Eg Euroinvestors, Response to CESR/10-394 and Euroshareholders, Response to CESR/10-394, suggesting that ‘the results are quite damaging to investors, particularly individual ones,’ that the cost of trading has not reduced, and suggesting that ‘MiFID has helped to further marginalize individual investors, despite the economic purpose of capital markets.’

202 Set out in CESR/09-324, *supra* note [*].

to price formation on main venues. France, in particular, is currently pursuing a transparency agenda,[203] and appeared to use its 2011 Presidency of the G20, and the G20 commitment to address unregulated sectors, to move equity trading from OTC venues to the formal RM/MTF space.[204] This concern reflects France's longstanding suspicion of competition in order execution which pre-dates the MiFID I negotiations and can be dated to earlier battles on the 1993 Investment Services Directive, and France's attempts then to prevent trading of French stock on SEAQ-International in London. Conversely, the UK FSA has found the MiFID framework to be 'generally satisfactory,' and is concerned about any moves toward a system which would protect 'national champions'.[205]

3.3 *The Implications for MiFID II*

While it is difficult to disentangle the legal drivers of change, MiFID I can be associated with changed behaviour and with a reallocation of equity trading benefits across interest groups. Some of this change can be clearly linked to MiFID I rules, particularly the abolition of the concentration rule; survey evidence suggests that market participants generally saw MiFID in terms of opportunity rather than as a regulatory burden.[206]

But market change can also be associated with MiFID I arbitrage dynamics. MiFID's sometimes ambiguous classification system has generated opportunities for the OTC sector to engage in functionally similar trading activities but outside the RM/MTF regime, particularly with respect to dark trading.

MiFID I has also struggled in achieving particular outcomes which it sought, notably reduced trading costs for investors and better transparency post-trade. The harmonization which has followed has also had perverse effects. One of the drivers for

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[203] AMF, *supra* note [*], suggesting that opaque areas should be limited to what is strictly necessary, and that all standardized and sufficiently liquid instruments should be brought on to multilateral platforms with high governance and transparency standards and non-discretionary open access.

[204] G20/Paris communiqué 2011. The AMF reported that it was on France's initiative that the Seoul G20 Summit gave IOSCO until June 2011 to report on market integrity and efficiency: *supra* note [*], 4.

[205] FSA, *supra* note [*], 23.

[206] Eg Gomber and Chlistalla, *supra* note [*] and CEPS, MiFID Review: What Next for European Capital Markets (2010).

poor post-trade transparency after MiFID has been the leveling-down effect; the new regime for OTC reporting was weaker than some Member State regimes in that it provided for more generous delays and for off-RM reporting.

The MiFID I experience therefore teaches that, while there are limits to what law can achieve, it can deliver transformative effects. But these effects may be driven by arbitrage dynamics and can be unpredictable. The pressure which extra-MiFID effects, including the growth of HFT, has placed on the MiFID I regime, also calls for care given the likelihood of unexpected outcomes when legal reform interacts with market change. The MiFID I experience also suggests that complex classification regimes which emerge from intense and febrile political negotiations, and which respond to sharply contrasting industry positions, can lead to unexpected outcomes. The competitive territory at stake under MiFID II may, however, lead to the Review being hijacked by entrenched interests and to similar difficulties (sections 4 and 5).

4. The MiFID Review

4.1 *CESR and reaction*

The opening salvo in the MiFID Review came with CESR's July 2010 Advice to the Commission, which was closely based on CESR's earlier April 2010 Consultation Paper. The Advice followed CESR's June 2009 empirical study on the equity markets, a 2009 industry roundtable, a series of industry meetings, and a specific fact-find on dark trading. It is hard to discern a clear theme through CESR's Advice, as it made piecemeal rather than radical proposals, but it was based on the assumption that MiFID was designed to promote competition between trading venues in order to increase investor choice, encourage innovation, lower transaction costs and increase the efficiency of price formation.

The pre-trade transparency proposals for RMs/MTFs were relatively uncontroversial. CESR recommended that the pre-trade waiver system, which supports RM/MTF dark pools, remain in place and that Member State discretion be retained. But CESR also called for a tightening of the scope of that discretion and suggested that the waiver regime become rules- rather than (as currently) principles-based, with EMSA

empowered to monitor the pre-trade regime and to propose related technical standards. With respect to the SI regime, CESR did not take a view on the 'appropriate number' of SIs. But it suggested that the Commission conduct a review and clarify the SI regime's objectives before major changes were made. It also made a number of specific proposals to address the risk that investment firms were avoiding classification as SIs. Its largely uncontested post-trade recommendations were designed to address the concerns as to the quality of post-trade information which had 'deteriorated significantly'.[207] CESR recommended that new standards address the clarity, comparability and reliability of post-trade information, that delays be shortened, and that pre- and post-trade information be unbundled separately by data providers. It also suggested that OTC firms be required to publish their post-trade information through an Approved Publication Arrangement (APA) and that APAs be approved and subject to stringent criteria designed to ensure the quality of data and to ongoing monitoring. CESR also proposed a European Consolidated Tape of transparency information, which would be developed by the industry, within a MiFID framework and time-frame.

On the controversial questions as to MiFID's classification regime and the treatment of the OTC markets, CESR's advice was conservative in some parts and ambitious in others. It recommended that RM and MTF requirements be aligned to the more prescriptive RM standards. CESR also recommended that the scope of the transparency regime be extended beyond shares to include 'equity-like' instruments including depositary receipts, ETFs (exchange-traded funds) and certificates. With respect to the contested question of MiFID's application in the OTC sector, and in particular to BCSs, CESR noted the 'considerable debate' and the need to establish a factual basis.[208] While it reported a low volume of trading through BCSs, it recommended that a tailored regime apply to firms operating BCSs – defined as internal electronic matching systems operated by an investment firm that execute orders against other client orders or house account orders.[209] CESR proposed that the bespoke regime

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207 CESR/10-394, 16.

208 CESR/10-394, 27.

209 CESR/10-394, 27.

include: notification by firms of BCS operation; publication of a list of BCSs; and a requirement for a generic BCS identifier in post-trade information which would support better data gathering on OTC trading. More controversially, however, CESR, drawing heavily (and problematically) on the US Alternative Trading System model,[210] recommended that a limit be posed on the volume of business which could be undertaken by BCSs and that once the limit was exceeded, BCSs would be required to become MTFs.

CESR also addressed issues relating to HFT, setting out the key themes which had emerged from its empirical work, and proposing an action plan.

The industry was, with some flash points, relatively supportive of CESR's precursor Consultation Paper,[211] which did not differ greatly from the final Advice. The BCS proposals, however, at the heart of the battle for territory between the informal OTC and formal RM/MTF space, generated sharp differences. Difficulties arose concerning the proposed definition, with some suggesting that BCS activity could be covered within the MTF/SI categories,[212] others considering the definition too broad,[213] and others calling for clear differentiation between the BCS, MTF, and SI sectors.[214] From the trading platform sector, FESE supported the introduction either of a new BCS regime, or the application of the SI/MTF regimes, depending on the nature of the trading.[215] Other respondents, particularly from the investment firm/OTC sector, questioned the need for intervention given the low volume of BCS trading,[216] the risk of a reduction in investor

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210 CESR/10-394, 27-28. Although CESR noted the differences between the EU and US regulatory systems.

211 In its response to the Commission Consultation, the BBA noted that the CESR Advice 'commands principled support from BBA members, and also we understand from market participants generally' (at 5).

212 CESR/10-975.

213 Eg, EBF, Response to CESR/10-394.

214 Eg Italian Banking Association, Response to CESR/10-394.

215 FESE Response to CESR/10-394. NYSE Euronext supported similar treatment of BCSs and dark MTFs: NYSE Euronext, Response to CESR/10-394.

216 Barclays Capital, eg, was 'surprised to see [BCS] included' given low trading volumes: Barclays Capital, Response to CESR/10-394.

choice,[217] and the inappropriateness of targeting systems which were an automation of the manual crossing functions carried out by firms providing execution services to clients.[218] This lobby was not, however, of one voice, with the European Banking Federation and others supportive of a specific regime.[219] Similarly, the London Stock Exchange took a more sanguine approach than FESE, suggesting that the relatively low volumes of BCS trading did not warrant a targeted approach and doubting the effectiveness of imposing a volume threshold on BCSs.[220] The controversial trading volume restriction was strongly contested by elements of the investment firm/OTC lobby. Arguments included that the MTF business model was fundamentally different to the discretionary, client-oriented BCS business model, and that any requirement to change business model from a BCS to an MTF would overlook the different trading functions provided by each venue.[221] The institutional investor community showed some support for a calibrated regime as well as scepticism concerning volume restrictions,[222] but the retail/individual investor tended to be supportive of the CESR proposal.[223]

Overall, CESR's Advice is characterized by cautiousness, pragmatism and a lack of dogmatism. CESR concluded that 'the key conclusion reached by CESR is that there is no need for a radical change to the MiFID framework but that important changes are required to address areas in MiFID which are not working effectively.'[224] By contrast with the European Parliament (below), CESR did not adopt a particular position on the appropriate size of the 'dark' OTC markets, save to highlight that a high degree of

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[217] AFME/BBA, Response to CESR/10-394.

[218] Deutsche Bank, Response to CESR/10-394.

[219] EBF, Response to CESR/10-394 and, eg, Citibank Global Markets and Barclays Capital Responses to CESR/10-394.

[220] London Stock Exchange Group, Response to CESR/10-394.

[221] Eg AFME/BBA, Barclays Capital, Deutsche Bank, and Citigroup Global Markets, Responses to CESR/10-394.

[222] Eg ABI, Response to CESR/10-394.

[223] Euroshareholders, Response to CESR/10-394.

[224] CESR/10-394, 32.

transparency was an essential element of the MiFID framework.[225] As suggested in section 5, ESMA should play a central role in the development of MiFID II. The 2010 CESR Advice suggests that it might be expected to take a restrained approach.

4.2 *The European Parliament Resolution*

The European Parliament has been keen to shape the MiFID Review and has emerged as sceptical of the OTC markets. In a hard-hitting 2010 Resolution,[226] which followed a summer 2010 'fact-find' on dark trading,[227] it expressed concern at the scale of OTC trading, called for trading on 'organized trading venues' to be encouraged and suggested that MIFID was intended to facilitate a shift to more regulated and transparent venues. The Resolution was hostile to the post-MiFID landscape. It suggested that market fragmentation had generated an 'undesired impact' on liquidity and efficiency, that a related decrease in transaction size had encouraged dark pool trading, that the RM/MTF waiver-based dark pool regime was more transparent and better regulated than the OTC dark pool system, and that the OTC sector enjoyed a comparative advantage under MiFID.

Its proposals, however, were relatively light-touch. The Parliament called for an in-depth investigation of the BCS sector, for ESMA to investigate the SI sector, and for an investigation of OTC trading generally. It called for thorough enforcement of MiFID, such that BCSs carrying out functionally-equivalent activities to SIs, MTFs, and RMs, were regulated as such, and, like CESR, called for a related notification system. It did not, however, propose a volume-based threshold for MTF conversion. Also like CESR, it supported the alignment of the RM and MTF regime. More radically, but vaguely, it called for improvements to be made such that OTC trading would decline substantially.

4.3 The December 2010 Commission Consultation and the October 2011 MiFID II Proposal

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[225] Eg CESR/10-394, 5.

[226] European Parliament Resolution, *supra* note [*].

[227] European Parliament Dark Pool Workshop, *supra* note [*].

4.3.1 *The December 2010 Consultation*

The Commission's MiFID II proposals were published on October 20 2011 and were preceded by a range of hearings,[228] two external studies by PriceWaterhouseCoopers and Europe Economics, and by the December 2010 MiFID Review Consultation. The Commission's first engagement with the MiFID Review – the 2008 'One Year On' conference[229] − was a relatively congratulatory affair, but Commissioner McCreevy underlined the core difficulties emerging with respect to data transparency and liquidity fragmentation. The Commission's April 2010 request to CESR for Advice revealed the Commission's concern to gather empirical evidence to support the Review.[230] In the subsequent September 2010 Commission Public Hearing Commission Barnier called for a pragmatic, objective and non-ideological approach.

These early indications of a potentially restrained approach were not fully reflected in either the subsequent December 2010 Consultation or the October 2011 MiFID II Proposal. The December 2010 Consultation was notable for the extent to which it departed from CESR's approach by suggesting a new and complex regime for classifying trading venues. It was also notable for its lack of empirical data. While detailed analysis was always likely to follow in any subsequent Proposal and related Impact Assessment, the rather sketchy approach taken in the Consultation nonetheless mattered, as it may have had the effect of entrenching interest group positions.

The key feature of the December 2010 Consultation was the introduction of a new trading venue classification – the 'Organized Trading Facility,' the operation of which would, like the operation of an MTF, be an investment service requiring authorization. The new OTF regime was only thinly justified; the Commission highlighted the need to capture new venues, respond to technological innovation, and address regulatory arbitrage. OTF operators would be subject to a range of rules, including notification requirements and operational requirements (including with respect to access, trading surveillance, and conflict of interest management). Reflecting CESR's approach to BCSs,

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[228] Six Commission roundtables were held. Impact Assessment, *supra* note [*], 7.

[229] *Supra* note [*].

[230] *Supra* note [*].

the Consultation also proposed that all OTFs be required to convert into MTFs when trading volume on the OTF reached a particular (undefined) threshold. The Commission also suggested that BCSs be subject to a sub-set of OTF rules and, in particular to a requirement to apply a BCS 'venue identifier' in their post-trade reports which would support data collection on BCS activity. Otherwise, the Consultation broadly reflected CESR's Advice. It called for an extension of the equity market transparency regime to equity-like instruments and for a tightening of the waiver regime for RM/MTF pre-trade transparency. In terms of data quality, the Commission followed CESR's approach and proposed that a new 'Approved Publication Arrangement' for the publication of trade data by OTC venues be adopted, and suggested three models for the potential consolidation of trade data into a 'Consolidated Tape'. More generally, it suggested that the RM and MTF regulatory regimes be aligned and that a regime for the regulation of algorithmic and high frequency trading be adopted.

The market response to the Commission Consultation, which was massive in scale,[231] was generally hostile, both from the trading platform/exchange and the OTC sectors. General concerns included: the lack of time to respond; poor empirical evidence and failure to engage with market structures and practices; a lack of detail and clarity as to the purpose of the reforms; the wide-ranging scope of the Consultation; a lack of proportionality between the measures proposed and the specific problems addressed, departures from CESR's advice in key respects; and the likely pressure which a new generation of detailed rules would place on ESMA. Member States in the European Securities Committee also raised concern as to the speed and perceived lack of transparency with which key proposals were being developed.[232]

Most difficulties arose concerning the new OTF classification. Criticisms from the OTC sector, at most risk of being pulled into the new classification, included the classification's breadth and lack of clarity, the failure to exclude traditional broker dealing activity, the focus on current venue types rather than on functionality, the danger

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[231] This analysis is necessarily highly selective given the massive scale of the response to the Consultation (some 4200 responses) and is based on from leading trading associations, major banks and major exchanges.

[232] ESC Minutes, 16 March 2011.

of a proliferation of different OTF venues, the need for flexibility, the potential risk to bilateral trading, the risk of unintended consequences, and the dangers of disproportionality, as the OTC sector was already regulated under the MiFID investment firm regime.[233] Trading platform/exchange sector concerns included whether a new classification (subject, potentially, to lighter rules) was an appropriate means of dealing with OTC trading, and why the Consultation had not focused on using existing classifications to capture trading with the same functionality.[234] FESE, for example, argued for a minimum number of mandatory venue types and called for a close analysis of the OTC markets to ascertain whether OTC trading was, in practice, falling within the current MiFID classifications.[235]

The CESR-style volume requirement for conversion from an OTF into an MTF was not well received. Respondents highlighted, for example, the different business model operated by MTFs and the distinction between functionality and trading volume, queried how a non-MTF could be converted into an MTF simply on reaching a potentially arbitrary threshold, and suggested that the evolution of trading from OTFs to MTFs should be investor driven.[236]

The precise role and scope of the OTC markets was also a recurring theme of responses. Some OTC sector responses, for example, called for explicit recognition and protection of the role of the OTC markets,[237] warned that there was no 'right-size' of OTC market,[238] and called for greater understanding of the nature and scale of OTC

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233 Variously Deutsche Bank, AFME, Goldman Sachs International, ICMA and BBA Responses to Commission Consultation.

234 Eg FESE Response to Commission Consultation. Similarly, Nasdaq/OMX Response, suggesting the new category could lead to more dark trading and calling for more careful application of the MiFID classifications. The London Stock Exchange Group, however, was more sanguine, although it raised concerned as to the absence of pre-trade transparency rules for the OTF sector.

235 NYSE Euronext similarly argued for a distinction between 'on' and 'off' market trading, and a distinction between multilateral and bilateral 'on' market trading.

236 Eg, variously, AFME, Deutsche Bank, ICMA, and BBA Responses to Commission Consultation.

237 Deutsche Bank Response to Commission Consultation.

238 AFME Response to Commission Consultation.

trading.[239] The trading platform/exchange sector, by contrast, raised concerns as to the volumes of equity trading occurring outside RM/MTF/SI venues and whether MiFID was driving trading OTC.[240] FESE, for example, argued that a significant volume of trading was taking place OTC, that the majority of dark trading was OTC, and that the extent to which OTC trading should be captured within the MiFID classification required close consideration.

As compared to the CESR Advice, the Consultation was a poorly-argued policy document which lacked a clear rationale, did not present supporting evidence, and introduced major changes to MiFID's organizational model without clear explanation. The Consultation was also very short on detail, relying heavily on the potential of implementing rules and on ESMA to provide relevant detail. Although the law-making process has since become significantly more sophisticated, the Consultation is similar in approach to the Commission's earliest consultations on the Investment Services Directive reform over 1999-2000.[241]

4.3.2 *The October 2011 MiFID II Proposals*

The October 20 MiFID II proposals followed the main themes established by the MiFID Consultation. The proposals have two elements: a Directive, which sets out the authorization and operating rules which apply to investment firms and regulated markets; and a Regulation, which addresses the transparency regime. The Regulation accordingly reflects the current movement towards a 'single EU rule-book' post-crisis, and is designed to 'establish uniform requirements' (Article 1), although both the Directive and the Regulation are characterized by the extent to which they provide for the adoption of detailed delegated rules and for ESMA's involvement.

The Regulation Proposal, central to the equity markets transparency regime, is supportive of MiFID I. Drawing on a series of Commission studies,[242] it suggested that

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239 *Ibid.*

240 Eg FESE Response and Nasdaq OMX Response to Commission Consultation.

241 Moloney, *supra* note [*].

MiFID led to more competition, wider investor choice, a decrease in transaction costs, and deeper integration. The Commission also suggested that the financial crisis experience has 'largely vindicated' MiFID's design. It highlighted, however, four difficulties. The benefits of competition were not flowing efficiently to all market participants and had not always been passed on to end users, and market fragmentation had made the trading environment more complex and opaque. MiFID's classification model had been outpaced by innovation. The financial crisis had exposed weaknesses in the regulation of non-equity instruments. Finally, rapid innovation and increasing market complexity called for higher levels of investor protection. The Commission thus sought a 'safer, sounder, more transparent and more responsible financial system.'[243]

At the core of the MiFID II proposals is the concern to extend the regulatory perimeter over trading venues to encompass a wider range of venues, and to apply the same set of rules to this wider set of venues. The Regulation Proposal is designed to 'ensure that all organised trading is conducted on regulated trading venues [RMs, MTFs and OTFs]….identical pre and post trade transparency requirements will apply to all of these venues.' Within the new perimeter, there is likely to be much less tolerance of self regulation by venues. A driving concern appears to be the 'future proofing' MiFID against future changes to the nature of organized trading and to address current and potential regulatory arbitrage risks.[244] A concern to shrink the OTC markets might also be regarded as implicit in the proposals, given the focus on increasing the range of regulated venues.

The RM and MTF rule-books are to be aligned, as they 'represent the same trading functionality'.[245] A new and detailed set of rules will apply to algorithmic trading and will apply to all regulated venues and to investment firms. [246] The SI regime is retained, but clearer and more detailed rules will apply, designed to distinguish clearly SI

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242 Including Oxera, Monitoring Prices, Costs and Volumes of Trading and Post-Trading Services (2011).

243 MiFID Regulation Proposal, 2-3.

244 MiFID Regulation Proposal, 7 and recital 7.

245 MiFID Regulation Proposal, recital 6.

246 MiFID Directive Proposal, Art. 12 (investment firms); Art 10, 20, and 51 (RMs

trading from OTC trading.[247] The most radical proposal, however, is the new OTF regime, which reflects the December 2010 Consultation.

The OTF regime is designed to capture all non-RM/MTF trading on organized venues, other than ad hoc bilateral trading between counterparties which does not take place on an organized venue. Investment firms and market operators operating MTFs and OTFs will be subject to identical transparency regimes, and to 'nearly identical' organization and market surveillance rules.[248] While there will be differentiation across the rules which will apply, differentiation will be at the level of the asset class traded, and not at the level of the venue. Thus, the transparency regime will be calibrated to reflect the particular features of equity and non-equity securities (MiFID II extends the equity market regime to non-equity securities[249]), but the same rules will be apply where similar assets are traded on different venues. While the new regime is designed to treat RMs, MTFs, and OTFs similarly, it nonetheless assumes one key difference, which has significant implications (as discussed in section 5) for the coherence of the regime. It assumes that the operators of RMs, MTFs, and OTFs are all neutral and that RMs and MTFs (reflecting the MiFID classification) offer non-discretionary order execution, and non-discretionary access. Reflecting the origin of OTF systems in bilateral trading, OTF operators, however, have a 'degree of discretion' over execution and can route orders to other venues. They should accordingly, be subject to conduct of business regulation and should not be permitted (to avoid conflict of interest risk) to execute client orders in the OTF against their proprietary capital.[250]

An OTF is defined as a system or facility which is not an RM or MTF, operated by an investment firm or market operator, in which multiple third party buying and selling interests in financial instruments are able to interact in a way which results in a contract.[251] OTFs would include BCSs, but not facilities (such as bulletin boards) which

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[247] MiFID Regulation Proposal, 9-10 and Arts. 13-20.

[248] MiFID Regulation Proposal, 7.

[249] *Supra* note [*].

[250] MiFID Regulation Proposal, 7 and recital 8.

[251] MiFID Regulation Proposal, Art. 2(1)(7).

do not support execution but only display trading interests.[252] OTF operators would, under the Proposed Directive, become subject to authorization requirements, similar to those which currently apply to investment firms and market operators operating MTFs. Accordingly, OTF operators will be subject to, inter alia, trading process rules and market surveillance rules, and the new algorithmic trading regime will apply. The OTF operator would, additionally, be required to explain why the system does not correspond to, and cannot operate as, an RM, MTF or SI. Unlike MTF operators, conduct of business rules would apply to the decision taken by an OTF operator to route a client order to the OTF. OTF operators will also be prohibited from executing client orders in the OTF against their proprietary capital (they cannot, accordingly, act as an SI). The Consultation proposal that OTFs convert to MTFs when trading volume reach particular thresholds is not, however, pursued under the Proposal.

With respect to the transparency rules, the Proposed Regulation applies the same set of equity transparency rules (pre and post) to RMs and to the operators (whether investment firms or market operators) of MTFs and OTFs. The rules will also be tightened, with ESMA empowered to issue an 'opinion' on the pre-trade waivers granted by national competent authorities, and charged with reviewing the waiver regime and proposing reforms. ESMA is also charged with monitoring the application of post-trade deferrals by national competent authorities. The new regime will also apply to equity-like instruments (including exchange-traded funds and depositary receipts). [253] The SI pre-trade regime will be significantly clarified and tightened.[254] All OTC venues (including Systematic Internalizers) will be subject to post-trade transparency obligations.

The MiFID II proposals also address data publication and consolidation in some detail. RMs and market operators and investment firms operating MTFs and OTFs will be required to 'unbundle' pre and post trade transparency date, to make its publication less costly. They will also be required to make all data available free of charge after 15 minutes. The CESR/Commission Consultation suggestion that OTC venues be required

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[252] MiFID Regulation Proposal, recital 7.

[253] MiFID Regulation Proposal, Arts. 3-6.

[254] MiFID Regulation Proposal, Arts. 13-16.

to publish through an Approved Publication Arrangement (APA) has also been retained. The Proposed Directive sets out the requirements for APAs, as part of the wider new authorization and regulatory regime which apply to 'data reporting services' (including APAs) more generally. [255] Data reporting services will also include Consolidated Tape Providers which will be subject to discrete organizational requirements, designed to ensure that Providers will be equipped to consolidate transparency data.[256]

5. The Way Forward

5.1 The Classification/Dark Trading Problem and Interest Groups

There is much to commend in the MiFID II proposals for equity market trading. The tightening of the pre-trade transparency regime for RMs/MTF waivers should bring greater consistency. The post-trade transparency proposals respond to a clear market need. The RM/MTF alignment proposals reflect the similar trading functionality of both systems. The fine-tuning of the SI regime should clarify its application. But there are significant weaknesses, particularly with respect to the key classification/functionality reforms and the treatment of dark OTC trading.

Dark OTC trading is not troublesome in itself, whether through bilateral OTC trades or through OTC systems, such as BCSs.[257] The benefits to investors include liquidity provision, price impact protection, and lower execution costs.[258] Dark pool trading also affords investors the ability to manage the risks arising from market developments; some major investors, for example, are reluctant to trade in lit markets

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255 Proposed MiFID Directive, Arts. 61-68.

256 Proposed MiFID Directive, Art. 67

257 For an analysis of the different venues on which OTC dark trading occurs see Degryse, van Achter, and Wuyts, Shedding Light on Dark Liquidity Pools (2008), available at http://ssrn.com/abstract=1303482 and IOSCO (2011), *supra* note [*].

258 Respondents to the IOSCO 2010 consultation identified the reasons for engaging in dark trading (whether on organized platforms or elsewhere) as including: minimizing information leakage; minimizing market impact; facilitating the execution of large blocks; ensuring better control over an order; protecting proprietary trading information; managing interactions with algorithms or other programs which seek out dark orders on lit platforms; taking advantage of price improvement possibilities; and minimizing transaction costs: IOSCO (2011) *supra* note [*], 11-12.

where high frequency traders are active, given the risks to their orders.[259] Brokers can use OTC systems to achieve better execution quality for their clients than that available in public lit exchanges, and so can meet best execution obligations more easily.[260] As much of the OTC market depends on reference prices from lit venues,[261] this dependence on the efficiency of public price formation is a natural brake on the scale of OTC trading.[262] The OTC trading sector is also not without regulation. Post-trade rules apply to all OTC equity trades, as do the general rules concerning organizational and conduct of business regulation which apply to investment firm trading. It is also clear that MiFID I provides for dark trading. Dark trading is supported through the MTF/RM transparency waiver system which allows MTF/RM dark pools to operate, by the limitations on the pre-trade information which SIs must provide, which allow much of SI trading to be dark, and by MiFID's treatment of the OTC sector as a dark market pre-trade.[263]

The difficulties arise where dark OTC trading is of a similar functionality to trading which is regulated under the RM/MTF classifications and so is primarily lit, and where arbitrage dynamics occur. Difficulties also arise where the volume of OTC dark trading threatens price formation on lit venues, and where related risks arise as to fragmentation, fairness, and market integrity.[264] But, as discussed in section 2 above, it is not clear that price formation is being prejudiced. In addition, evidence of a market failure is in itself not sufficient to justify regulation – the benefits must outweigh the costs. Resolution of the dark trading question is rendered all the more difficult by the existence of entrenched interests and the market territory which is at stake.

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[259] European Parliament Dark Pool Report, *supra* note [*], 11. Similarly, ABI, Response to CESR/10-394.

[260] European Parliament Dark Pool Report *supra* note [*], CESR Presentation.

[261] Dark pools prices are often referenced to those on the main lit markets: IOSCO (2011) *supra* note [*], 13.

[262] European Parliament Dark Pool Workshop *supra* note [*], 10. Similarly, Celent Report *supra* note [*].

[263] It has been described as allowing for a substantial fraction of trading to take place in the dark: Degryse, de Jong, and van Kervel, The impact of dark and visible fragmentation on market quality (2011), available at http://ssrn.com/abstract=1815025.

[264] Eg, IOSCO (2011), *supra* note [*], 21-24.

Order execution regulation in the equity markets is ultimately directed towards the efficiency of the market and the ease with which resource allocation between capital-supplying investors and capital-seeking issuers occurs. Reform must accordingly seek to support market efficiency - and not simply address the competition issues raised by the trading services sector, whether OTC or organized venues. The MiFID Review, however, has been largely dominated by the major OTC and organized venues, and not by issuers and investors – even allowing for the MiFID II proposal for a new 'SME growth market' segment.[265] The danger has therefore arisen of intermediary interests, reflecting rent distribution concerns, dominating the reform debate. The prominence of BCSs in the initial stages of the MiFID Review, and the centrality of the OTF reform to the MiFID II proposals, certainly suggests some distortion by interest groups of the Review. This is problematic for a number of reasons.

Obsolescence is a key risk where major classification decisions become a function of current industry fault-lines, rather than of objective consideration of distinctive market functionalities, as the fate of the MiFID I regime for systematic internalizers suggests.

Where the objectives of the new MiFID II regime reflect industry interests, additional risks arise. MiFID I was designed to introduce competition in the order execution market and to protect against the risks of fragmentation. But it was a relatively light-touch measure with respect to market micro-structure. The venue classification system was designed to support competition and investor choice.[266] MiFID did not specify the relative size of the OTC and other markets, leaving this to market dynamics. It did not, unlike US Regulation NMS, intervene heavily in market microstructure. While difficulties have arisen with MiFID I, there is little evidence to suggest that the current approach is fundamentally flawed. The MiFID II process, however, may be recasting MiFID's core objectives. There are, for example, some indications that MiFID II may be designed to reduce the scale of dark OTC trading by expanding the range of venues subject to transparency and other rules under the new OTF regime. The OTF

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[265] Proposed MiFID Directive, Art. 35. The proposed regime would provide MTFs with the possibility of registering 'SME growth market' segments designed to enhance SME visibility, but which would remain subject to a lighter regulatory regime than applies to more mature and larger issuers on RMs.

[266] Eg, Gadinis, *supra* note [*], describing MiFID as deregulatory and decentralized.

classification is formally designed to deal with regulatory challenges posed by BCS, to address the transparency and arbitrage difficulties posed by trading on non-regulated venues, and to provide a dynamic framework which captures future developments.[267] But the Commission has also argued that the new OTF regime 'should decrease the weight of OTC trading in equities and non-equities.'[268] This rationale, and the related OTF regime, can be associated with the framing of the MiFID II debate by dominant intermediary concerns. But this orientation to the MiFID II reforms is problematic for a number of reasons.

It is not necessarily the case that MiFID should, or can, make a determination as to the appropriate levels of OTC equity trading, or use law to create incentives for moving trades on to organized venues. The OTC markets fulfill important functions in providing additional liquidity, minimizing market impact risk, and supporting investor choice. Market demand should drive the size of different segments, not regulatory pre-determination and the EU should be wary of intervention, absent clear evidence as to damage to price formation or to fair competition. In particular, the new OTF regime may have unexpected effects. The Commission has estimated that 9 BCSs and 10-12 other systems will come within the new OTF regime, and suggested that the costs will be in the region of €4.2 to €11.3 million.[269] But the breadth of the OTF definition, combined with the unexpected effects which experience with MiFID I suggests are likely, does not allow for complacency, particularly given the limited empirical data on the scale and structure of the OTC markets and the lessons from MiFID I as to the risks of intervention.

Similarly, the data collected so far does not suggest that the MiFID I regime is not 'fit for purpose'. It captures, to a reasonable although not perfect degree, the essential difference between bilateral order execution services where broker/firm capital is at risk (OTC), and multilateral open access systems (RMs/MTFs), as seems to be accepted by the European Parliament.[270] Member States also seem to support the current

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[267] Impact Assessment, *supra* note [*], 34-35.

[268] Impact Assessment, *supra* note [*], 35-36.

[269] Impact Assessment, *supra* note [*], 36 and 160.

classification, based on recent discussions in the European Securities Committee.[271] The MiFID II proposals, however, will lead to a six-tier system: regulated markets; multilateral trading facilities; SME growth market multilateral trading facility; systematic internalizer; organized trading facility; and over the counter trading. It is likely to generate legal uncertainty, confusion, overlap, and arbitrage risks. The very wide OTF definition may, for example, struggle to capture OTC trading in an optimal manner which enhances transparency in an efficient and fair manner. OTFs are also often highly complex and reflect distinct proprietary models.[272] Some OTFs, for example, operate as 'black boxes' which are based on multiple algorithms which capture incoming client orders and decide whether they should be executed internally through SI systems, in the firm's OTF, routed to another venue, exposed to a 'bulletin board,' or treated in another manner. It is unlikely that the blunt OTF classification, and the ranges of rules which follow once it is activated, will appropriately capture the distinct elements of the 'black box' which require regulation as an OTF. The difficulties are all the greater as OTFs of this type are typically designed to assist investment firms in meeting their process-based best execution obligations under MiFID Article 21. It would be quixotic were the MiFID II reforms to render it more difficult for firms to achieve best execution, with consequent prejudice to the end investor. The investor may also be prejudiced by the prohibition on OTF operators from trading in the OTF system with their proprietary capital. Currently, it is not uncommon for OTF operators to provide capital to their OTF systems, in order to deepen liquidity, but under MiFID II only SIs will be allowed to use their capital to trade against client orders. This prohibition may decrease OTF liquidity and stability, and ultimately prejudice investors. The OTF classification also represents an unhappy muddle of organized venue and bilateral trading concepts. The OTF is treated as a venue, and subject to the same rules as MTFs and RMs. But the MiFID II proposals also treat the

[270] The European Parliament Resolution (*supra* note [*]) suggests that the classification be kept simple, with venues treated as either MTFs, SIs or OTC. The Celent Report (*supra* note [*]) similarly suggested that MiFID is based on a functional bilateral/multilateral distinction, and this functionality-based approach be retained.

[271] ESC Minutes, 16 March 2011, reporting that many Member States were concerned as to the new venue and the possibilities for arbitrage.

[272] The Impact Assessment notes the complex range of functions which OTFs can offer, but does not engage closely with how these should be regulated: *supra* note [*], 122.

OTF operator as an investment firm subject to conduct of business regulation, in an attempt to capture the distinct discretionary nature of OTF trading. But one of the key distinguishing features of venue regulation is that client-facing conduct rules do not apply. MiFID II thus introduces a new hybrid animal into the trading environment: one with the head of a venue grafted on to the body of an investment firm. The application of conduct rules to the OTF underscores the conceptual difficulties which an overly extensive approach to venue regulation can generate. The dangers of regulatory error are all the greater as the MiFID II proposals will close further the gap between private and public markets in the EU and, accordingly, place greater pressure on the quality of public regulation.

The OTF regime may also have led the MiFID Review to overlook a key issue. As noted in section 2, RMs and MTFs have the same trading functionality, as has been acknowledged in the MiFID II proposals which seek to align the trading rules applicable. But MiFID II retains the distinction between RMs and MTFs, although the RM label is a branding device, designed to signal the quality of particular public markets for the purposes of issuer access to trading markets and investor protection. The opportunity seems to have been lost to simplify the system, and to reflect trading functionality more accurately, by re-orienting the system towards the regulation of market operators generally. The venue classification could be based on just two classes: market operators of MTFs (as the MTF venue is wider than the RM venue); and the OTC sector (with the SI regime as a sub-set of the OTC sector). Three revisions would be required to the current regime. First, RMs would no longer require authorization as RMs, but market operators would be authorized to operate both RMs and MTFs. The distinctive, issuer-facing features of RMs would remain, but would not dictate the trading venue classification system. Second, operating an MTF would no longer be an investment service – an increasingly awkward designation - but a distinct activity, covering MTF operation as well as the operation of RMs as a specific type of MTF. Third, market operators seeking to operate RMs and MTFs would be subject to a discrete authorization and operating regime, similar to regime which currently apply to RMs under MiFID I.[273]

A regime of this nature would introduce significantly greater conceptual coherence and remove lingering inequities in the treatment of RMs and MTFs.

5.2 *A Modest Proposal*

There are, of course, difficulties. The current MiFID I classifications are, reflecting MiFID's structure as a level 1 directive, loosely cast. Delegations to level 2 were not made, save with respect to the SI regime, reflecting the sensitivity of the MiFID I negotiations. The discretionary/non-discretionary and bilateral/multilateral concepts which govern functionality are troublesome and fluid. Market participants have taken a range of conflicting positions on how different functionalities fit within these concepts, and some degree of arbitrage seems unavoidable. The Celent Report certainly suggests that OTC trading is taking place which is not within the spirit or the terms of the MiFID I classification system, particularly with respect to small orders. As noted in section 4, it is also clear that opinion is fractured across the industry, and within particular industry sectors, as to how a new venue classification regime should proceed.

But a more incremental and evidence-based approach is called for. This article suggests a three-pronged approach to equity trading market reform.

First, reflecting the difficulties which it has generated, MiFID I should be revised, but the revision should have a light touch and be closely based on empirical evidence. Scarce regulatory resources and political capital would be best targeted to the complex data consolidation problem, which is of acute market concern. While the scale and nature of the OTC markets requires attention, the response should be more carefully targeted. The 2010 CESR Advice and Commission 2010 Consultation contained proposals for BCS post-trade transparency reports to have a generic venue identifier, which would allow the market and regulators to assess the scale of this trading. These proposals do not appear to have been adopted in the final October 2011 proposals and would be useful. Identifier issues have arisen before; the SI regime requires that the particular SI identify itself in transparency reports (unless it complies with MiFID I reporting requirements

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[273] A similar merger of the RM and MTF classifications was suggested by Chi-X in its response to CESR/10-394.

which allow a generic OTC identifier to be used).[274] On the downside, the currently limited scale of BCS trading does not warrant special treatment and identifier requirements demand a clear definition. On the upside, market conditions can change and the attractiveness of dark trading, combined with the limitations of RM/MTF dark trading, suggest BCS trading is unlikely to reduce in volume.

Second, significant delegations to technical rule-making (and in particular to the adoption of the 'technical standards' which ESMA is empowered to propose to the Commission) should be made to address technical and definitional weaknesses, such as those in the SI regime. This would bring ESMA's technical expertise, and links to the market, into the law-making process more fully. While the MiFID II Proposal does rely heavily on ESMA, this reliance should, particularly given potential resource strain in ESMA, be targeted to fine-tuning the current regime.

In a related point and finally, extensive alteration of the venue classification system, and in particular the adoption of OTF model, should be avoided. Instead, stronger convergence on supervisors' approaches to, and enforcement of, the MiFID classifications is required. National competent authorities take different approaches to the RM/MTF pre-trade transparency waiver system, for example, as noted *supra.* They also take different approaches to the intensity with which they apply MiFID.[275] The uneven concentration of different trading sectors across Europe (the SI industry is largely based in the UK, for example, while 75% of all RM/MTF trading under the 'large in scale' dark trading waiver takes place in one Member State[276]) also suggests that experience with classifying different forms of trading activity varies across the EU. Much of the MiFID I regime is still relatively new, and competent authorities have had few precedents to rely on. ESMA provides a means for securing greater convergence on the interpretation and enforcement of the current classification system and, accordingly, of limiting arbitrage. ESMA should accordingly be enjoined to adopt guidance on how the MiFID

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274 MiFID Level 2 Regulation Art. 27(2), which requires that aggregate quarterly data concerning transactions executed as an SI be disclosed.

275 Eg, the FSA's risk-based approach has led it to treat MTFs with a similar market impact or share to RMs in the same way, despite differences in the regulatory structure: FSA, *supra* note [*], 11

276 CESR/10-802.

classifications apply in practice, and to monitor supervisory and market practice to this end. The threat of intervention implicit in closer monitoring and in stronger convergence should also not be discounted as a control on arbitrage activities; evidence emerged of a degree of self regulation within the BCS sector in advance of the MiFID Review.[277] A permanent reform cycle is not, of course, desirable and would lead to market uncertainty and confusion over business models. Neither should MiFID II be an interim stage en route to MiFID III. On the other hand, a clear case for a major reworking of MiFID I has not been made out. The safer approach may be to rely on the current venue classification regime, with guidance to come from ESMA as to which trading functionalities fall within the different classifications, and ESMA proposals for related binding technical standards as necessary. The ESMA-led system for agreeing on RM/MTF dark trading waivers provides a useful template. A commitment to ongoing review of, and greater convergence with respect to, the application of MiFID in practice may also mean there is greater political energy and capital available to the co-legislators to streamline MiFID I, and, in particular, to adopt a simpler approach to venue classification based on the binary market operator/ OTC model, outlined *supra.*

This modest proposal demands much of ESMA and resources are limited. But ESMA is becoming increasingly experienced as a new authority,[278] and CESR's approach to the early stages of the MiFID Review suggests that ESMA is already well-versed in the issues, has established good communication lines and trust with major stakeholders, and would adopt a restrained approach.

6. Conclusion

With the MiFID Review, the EU is facing its first major test of law-making effectiveness with respect to financial market regulation generally, now that the main elements of the crisis-era reform programme are in place. The law-making technology at the EU's disposal has become significantly more sophisticated with the establishment of ESMA in 2011. But the MiFID Review poses particular risks arising from the sensitivity of equity

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277 European Banking Federation, Response to CESR/10-394.

278 Moloney, *supra* note [*].

market structure to the MiFID reforms, the regulatory complexities, and the sharp influence of interest groups. Given the evidence presented in this article of the MiFID I experience, the success of MiFID II will depend in large part on the extent to which the co-legislators, battle-hardened from the crisis-era reforms, will be equipped to take a disinterested, market efficiency-driven, and, this article suggests, 'light-touch' approach to MiFID II.

List of Acronyms

AFME	Association of Financial Markets in Europe
AMF	French Autorité des Marchés Financiers
ASIC	Australian Securities and Investments Commission
BBA	British Bankers' Association
BCS	Broker Crossing System
CESR	Committee of European Securities Regulators
EBF	European Banking Federation
ESMA	European Securities and Markets Authority
ECOFIN	Economic and Financial Affairs Council
FESE	Federation of European Securities Exchanges
FSA	UK Financial Services Authority
FSAP	Financial Services Action Plan
ICMA	International Capital Markets Association
IOSCO	International Organization of Securities Commissions
MiFID	Markets in Financial Instruments Directive
MTF	Multilateral Trading Facility
OTC	Over the Counter
OTF	Organized Trading Facility
RM	Regulated Market
SEC	US Securities and Exchange Commission
SI	Systematic Internalizer
SMS	Standard Market Size