Factsheet
Dec 2011

Markets in Financial Instruments Directive (MiFID) and Regulation (MiFIR)

The Markets in Financial Instruments Directive (MiFID) is one of the many laws the European Union has set up concerning the financial markets and companies, funds and banks active on them. MiFID is one of the most important laws, as it generally covers all kinds of financial instruments and also a broad range of actors.

1. MiFID 1

MiFID came into force in 2007, shortly before the financial crisis. It was a follow up to former, less ambitious laws on these markets. The reasoning of these former laws as well as MiFID was not to control financial instruments but to create a common internal market and more competition amongst trading platforms. Therefore, MiFID created so called “multilateral trading facilities” (MTF) which were allowed to operate next to the so-called “regulated markets” such as stock exchanges. Rules that tried to regulate the competition by requiring trading on regulated markets were abolished. And indeed, new platforms emerged and tackled the dominance of the regulated markets. More and more trading takes place there. However, it went beyond that. Trading also flourished outside of any trading platform on the bilateral “over-the-counter” (OTC) markets. These markets are set up by banks and specialised investment firms. All these developments led to so-called “dark markets” or “dark pool” trading. MiFID encouraged the explosion of these markets – and contained nothing to prevent the financial crisis.

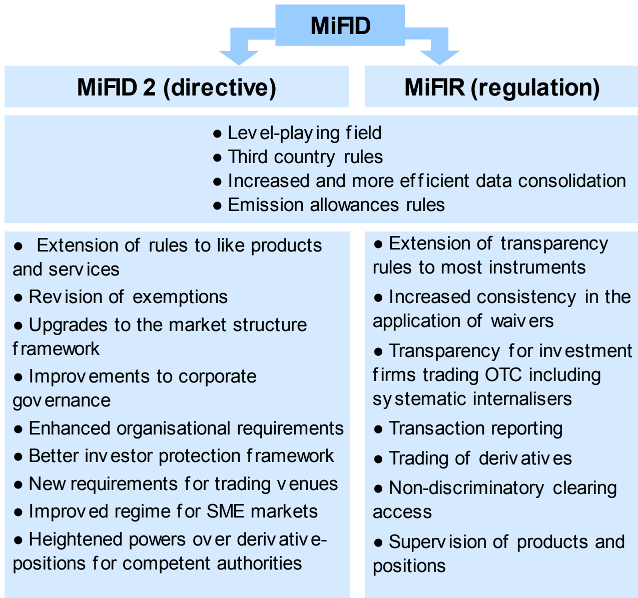
2. MiFID 2 and MiFIR

MiFID is currently being revised. After a long period of internal discussions, the Commission released proposals for a revision of MiFID and for a new regulation on the same issue (Markets in Financial Instruments Regulation – MiFIR, cf. chart 1) on 20 October 2011. Moving part of the contents to a regulation would mean that they have a direct validity throughout the EU without implementation by Member States. The European Parliament and the Council will now have to take a position on the basis of the Commission proposals. As can be seen in Table 1, the revision will extend until autumn 2012 at least and likely until 2013 for the final negotiations with the European Council.

Table 1: European parliament MiFID revision process

Event	Date
First exchange of views	13 February 2012
Presentation of the draft reports	24 April
Deadline for amendments	10 May
Consideration of amendments	18/19 June 2012f
Vote in ECON	9/10 July or Sep 2012
Plenary vote	Nov/Dec 2012

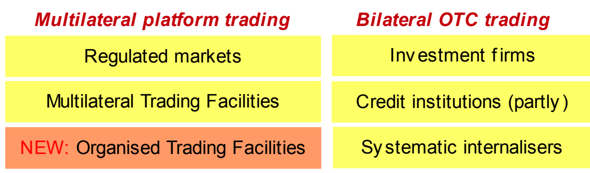
Chart 1: MiFID revision overview



3. Dark markets and transparency

The huge dark market created by MiFID seems to worry the Commission. Thus it is now proposing new rules to bring back some light. Amongst others, it has proposed the creation of a new, third type of multilateral “organized trading facility” (OTF, cf. chart 2). What an OTF will be, however, remains vague, especially in comparison to the existing multilateral trading facility. Furthermore, pre- and post-trading transparency requirements, such as publishing public quotes, prices, volumes and execution times, are extended beyond equity instruments to bonds, structured products and derivatives by MiFIR. Transactions also have to be reported to authorities. However, part of the OTC trading will remain dark. MiFIR requires trading of derivatives by “financial counterparties” mainly on multilateral platforms, and – as EMIR – requires clearing, i.e. a kind of centralized and collateralized trading, by regulated markets.

Chart 2: Multilateral and bilateral trading in MiFID 2



4. Algorithmic and high-frequency trading

Algorithmic trading which is automatically executed by computers already represents the majority of trading on many financial markets today. A sub-form of this trading is high-frequency trading, which means buying and selling a financial instrument within a very short time up to milliseconds.
As both trading forms can very likely cause erratic price movements and huge price leaps, MiFID requires new controls for algorithmic trading. Investment firms need to have "effective systems and risk controls" and "trading thresholds and limits" in place to "prevent the sending of erroneous orders". Investment firms need to "ensure that algorithmic trading systems cannot create or contribute to disorderly trading conditions". Regulated markets and MTF – but not OTF – need to have "systems, procedures and arrangements" that "reject orders that exceed pre-determined volume and price thresholds or are clearly erroneous", and also be "able to temporarily halt trading".

5. Commodity derivatives and speculation

Following the recent commodity price spikes and criticism of food speculation by Internal Market Commissioner Michael Barnier, the Commission is proposing two particular rules for commodity derivatives (and emissions allowances) markets.
The first requires real-time reporting by traders to the platforms and a weekly report by trading platforms with a "complete breakdown of the positions" for the "different categories of traders" like funds, credit institutions, commercial undertakings, etc. The second requires member states to ensure that all multilateral trading platforms have "limits on the number of contracts" which any trader "can enter into over a specified period of time", i.e. position limits. However, "alternative arrangements with equivalent effect" shall also be allowed. The measures shall be set "to (a) support liquidity; (b) prevent market abuse, or (c) support orderly pricing and settlement conditions".
Additionally, a far-reaching exemption for companies "dealing on own account in commodities and/or commodity derivatives" would be deleted. This takes into account that commodity firms might also pose a risk to market stability and that they perform a good deal of speculative trading, instead of just hedging risks from their physical commodity business.

6. Prohibitions and regulatory oversight

The EU will have a much stronger role in overseeing and controlling the securities and derivatives markets than before. In many cases, MiFID and MiFIR give the Commission and the ESMA the task of developing numerous technical standards.
ESMA and the member states' competent authorities have shared and parallel powers to intervene on markets which are subject to various preconditions, however. Prohibitions on single traders or part of their trading practices are possible, but optional on a single-case basis. In the case of position limits, the Commission and ESMA shall ensure a coherent approach throughout the EU.

7. Shortcomings and loopholes

There are many shortcomings and loopholes in MiFID; only some of the most important ones can be named here:
Generally, the financial crisis and its lessons are not sufficiently taken into account: the usefulness of the financial markets in general, and derivatives in particular, remains unquestioned.
The harmful dark markets leading to a loss of regulatory oversight will not be closed down. The organized trading facilities are no panacea to this development.
The weekly report for commodity markets needs to be compiled and released by ESMA and not by the platforms themselves, as this could end in diverse forms of information without any use.
The MiFID has no precautionary approach despite many negative experiences with financial markets. One example is that the application of position limits does not include a preventive application. In the US, the authorities are required to "prevent" excessive speculation.
The position limits are much too weak: they can be circumvented by platforms with "alternative arrangements" and by traders via the OTC markets. The limits should also apply to classes of traders, not only to single traders, and be set by the authorities, not by trading platforms. They should be defined in more detail, including a provision that they should cover spot, single and all delivery months in order to prevent the rolling of funds in front of the spot month. Exemptions, if any, should be clearly defined in the MiFID.
There are no clear prohibitions for certain types of trading in commodity markets, such as high frequency trading or trading by funds, especially index funds.

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Further reading

European Commission Website on MiFID

Make Finance Work (on MiFID and Food Speculation)

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