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MiFID II: The Regulation of Market Makers

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MiFID II introduces new laws addressing various structural and other issues relating to the operation of trading venues. Market making activity on such venues will now be subject to extensive regulation. This includes a commitment by the market maker to the trading venue to make available prices for particular minimum times and to abide by various related systems and controls obligations. Trading venues will also be required to have agreements with their market makers and to ensure that any incentive arrangements are fair and non-discriminatory. There are new rules that will apply to market makers that use algorithmic trading, including high frequency trading strategies.

Introduction

This memorandum discusses the regulation of market making under the new Markets in Financial Instruments Directive (“MiFID II”)¹ and the Markets in Financial Instruments Regulation (“MiFIR”)². It is one in a series of client notes that will discuss the changes that the revision of the original MiFID will bring about come 3 January 2017.

Scope of New Obligations: What is a Market Maker? What is a Market Making Strategy?

Market making is not subject to any specific regulation in MiFID I, albeit it is an activity that falls within scope of “dealing on own account.”³ This remains unaltered in MiFID II, with some modifications for commodity markets.⁴ A new exemption⁵ will apply for “persons dealing on own account, including market makers, in commodity derivatives or emission allowances or derivatives thereof, excluding persons who deal

¹ Directive 2014/65/EU

² Regulation (EU) No 600/2014.

³ Directive 2004/39/EC, MiFID I, Article 2.1(d).

⁴ This is set out in Recital 8 and Article 2.1(d) of MiFID I, and continued in Recitals 18, 20, 23, 50; 2.1(d)(i) of MiFID II.

⁵ MiFID II, Article 2.1(j).

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on own account when executing client orders”, provided that: (i) such activities are ancillary to the main business; (ii) it does not involve high frequency trading (“HFT”); and (iii) there is an annual notification to the relevant national regulator of reliance on the exemption.

MiFID II defines a ‘market maker’ as “a person who holds himself out on the financial markets on a continuous basis as being willing to deal on own account by buying and selling financial instruments against that person’s proprietary capital at prices defined by that person.”⁶ The definition is almost identical to that in MiFID I.⁷

By contrast, the Short Selling Regulation⁸ has a different definition of “market making activities” that refers to the activity of:

- posting firm, simultaneous two-way quotes of comparable size and at competitive prices, with the result of providing liquidity on a regular and ongoing basis to the market;
- as part of its usual business, fulfilling orders initiated by clients or in response to clients’ requests to trade; and
- hedging positions arising from the fulfilment of tasks under points (i) and (ii).

It is clear, and acknowledged in MiFID II, that the definitions are intended to operate independently. The focus of the new rules in MiFID II is on market making strategies carried out by algorithmic trading firms, including HFT firms. In this context, there is a further definition of “market making strategy” in MiFID II, namely: “when, as a member or participant of one or more trading venues, its strategy, when dealing on own account, involves posting firm, simultaneous two-way quotes of comparable size and at competitive prices relating to one or more financial instruments on a single trading venue or across different trading venues, with the result of providing liquidity on a regular and frequent basis to the overall market.”⁹

In its Discussion Paper on Level 2 measures¹⁰, ESMA sets out its view that the requirement of “simultaneity” should only be assessed on a per-second basis, i.e. “the quotes should be in both sides of the order book at the same second.”¹¹ ESMA’s preliminary view is that “the prices should be within the maximum bid/offer spreads that are required from market makers recognized under the rules of the trading venue.”¹²

⁶ MiFID II, Article 4.1(7).

⁷ MiFID I, Article 4.8. Except for the substitution of “that person” for “him” at the end.

⁸ Regulation (EU) No. 236/2012, Article 2.1(k).

⁹ MiFID II, Article 17.4.

¹⁰ ESMA Discussion Paper on MiFID II/MiFIR.

¹¹ ESMA Discussion Paper on MiFID II/MiFIR, pg 263.

¹² ESMA Discussion Paper on MiFID II/MiFIR, pg 263.

Market Making Activities by Algorithmic Trading Firms

Where market making is carried out by algorithmic trading firms,¹³ including HFT firms,¹⁴ such firms must:

- carry out market making continuously during a specified proportion of the trading venue's trading hours, except under exceptional circumstances, with the result of providing liquidity on a regular and predictable basis to the trading venue;
- enter into a binding written agreement with the trading venue; and
- have in place effective systems and controls to ensure that it fulfils its obligations under the agreement.¹⁵

The significance of this is that algorithmic trading firms can only benefit from fee rebates and incentives offered by a trading venue if they are also engaged in market making.

ESMA will present technical standards to the European Commission by 3 July 2015 on "the circumstances in which an investment firm would be obliged to enter into the market making agreement ... and the content of such agreements, including the proportion of the trading venue's trading hours" during which the market making must take place.¹⁶ ESMA's current thinking is set out in its Discussion Paper on Level 2 measures.

ESMA proposes to require such agreements to include provisions on:

- maximum spread of the quotes (usually on a percentage basis from the best bid and offer);
- minimum quotation value (i.e. the smallest permissible value on both bid and offer); and
- presence requirements (for example, 80% of the trading hours).¹⁷

ESMA also proposes a "minimum non-exhaustive list of quoting parameters which would leave room for trading venues to design the most adequate market making agreement according to the instruments traded, their trading and business model."¹⁸

In addition, ESMA's proposals include extensive systems and controls requirements for algorithmic trading firms:

- separate identification of market making orders from other orders (e.g. client orders);
- maintaining records to identify market making orders against other proprietary activities;
- immediate availability of records to competent authorities upon request;
- internal procedures to identify market making activities;

¹³ Algorithmic trading is where "a computer algorithm automatically determines individual parameters of orders such as whether to initiate the order, the timing, price or quantity of the order or how to manage the order after its submission, with limited or no human intervention, and does not include any system that is only used for the purpose of routing orders to one or more trading venues or for the processing of orders involving no determination of any trading parameters or for the confirmation of orders or the post-trade processing of executed transactions." MiFID II, Recital 39.

¹⁴ High frequency trading more generally will be treated in a separate client note published as part of our MiFID II series of notes.

¹⁵ MiFID II, Article 17.3 – 17.4 and Recitals 59 – 61.

¹⁶ MiFID II, Article 17.7(b).

¹⁷ ESMA Discussion Paper on MiFID II/MiFIR, pg 265, para 29.

¹⁸ ESMA Discussion Paper on MiFID II/MiFIR, pg 265, para 30.

- appropriate and effective surveillance, compliance and audit resources;
- a framework to enable adequate monitoring of market making activities (alerts, indicators);
- mechanisms which seek to prevent any market disruption or any significant price deviation due to a malfunction of an algorithmic trading strategy;
- an emergency device that allows a manual stop of algorithmic trading activities (“kill switch”);
- remuneration schemes for staff dedicated to the market making activity which do not: (a) incentivise disproportionate risk taking; (b) impede compliance with the obligation of the firm to act in the best interests of clients; or (c) encourage non-compliance with the market making scheme;
- direct or indirect access to relevant clearing and settlement systems; and
- a commitment to settle, close or transfer all open positions to another member in case of a retreat from the market.¹⁹

In addition, all the other new requirements related to algorithmic trading and HFT apply equally to market making by those firms. These include more general requirements as to resilience, systems and controls, breakers/thresholds and limits, regulatory authorisation and regulatory supervision.

Obligations on Trading Venues

Several European jurisdictions, including the UK,²⁰ have rules requiring exchanges to operate “proper markets,” in some cases with specific reference to how market making or liquidity schemes are administered. However, these issues have not been subject to any regulation at the EU level. MiFID II imposes new rules that apply not only to regulated markets but also to MTFs and OTFs.²¹ This makes certain of the self-regulatory responsibilities previously associated with regulated markets compulsory for all types of trading venues.

MiFID II now requires regulated markets and operators of MTFs and OTFs to:

- have in place written agreements with all investment firms pursuing a market making strategy. This must set out liquidity obligations and incentives (e.g. fee rebates).²² ESMA proposes that minimum times of market presence should be specified;²³
- monitor and enforce compliance with such agreements;²⁴
- notify the national regulator of the content of the agreements;²⁵

¹⁹ ESMA Discussion Paper on MiFID II/MiFIR, pg 266, para 34.

²⁰ Section REC in the FCA Handbook; Financial Services and Markets Act (2000) (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001.

²¹ MiFID II, Article 18.5.

²² MiFID II, Article 48.2(a) and Article 48.3.

²³ ESMA Discussion Paper on MiFID II/MiFIR, pg 265, para 29.

²⁴ MiFID II, Article 48.3.

²⁵ MiFID II, Article 48.3.

- ensure that fee structures are “transparent, fair and non-discriminatory.”²⁶ ESMA recognises that fee rebates and volume discounts may be appropriate. Trading venues should also be entitled to set volume limits and penalise higher levels of trading volume; and
- ensure that market making schemes do not contribute to a disorderly market. ESMA highlights so-called “wash trades” or “churning” as a particular risk if firms are incentivised to submit trades without a commercial rationale.²⁷

These requirements will be fleshed out by ESMA by way of technical standards which will be presented to the Commission by 3 July 2015. The Discussion Paper will form the basis for a later consultation paper on proposed technical standards.

New Access Requirement for Organised Trading Facilities (OTFs)

A new provision aims to prevent OTF operators being confined to providing market making themselves or relying on firms that are affiliated with them for market making.²⁸ Member States will not be able to prevent an investment firm or a market operator operating an OTF from engaging another investment firm to carry out market making on that OTF on an independent basis. For such purposes, an investment firm shall not be deemed to be carrying out market making on an OTF on an independent basis if it has close links with the investment firm or market operator operating the OTF.

²⁶ MiFID II, Article 48.9.

²⁷ ESMA Discussion Paper on MiFID II/MiFIR, pg 283, para 19.

²⁸ MiFID II, Article 20.5.