Guido Ferrarini and Paolo Saguato

Reforming securities and derivatives trading in the EU: from EMIR to MiFIR

Article (Accepted version) (Unrefereed)

Original citation:
Ferrarini, Guido and Saguato, Paolo (2013) *Reforming securities and derivatives trading in the EU: from EMIR to MiFIR*. Journal of Corporate Law Studies, 13 (2). pp. 319-359. ISSN 1473-5970 DOI: 10.5235/14735970.13.2.319

Reforming Securities and Derivatives Trading in the EU: from EMIR to MIFIR*

Guido Ferrarini† and Paolo Saguato‡

The financial crisis has generated a deep revision of the regulation of securities and derivatives markets. In this paper, we critically examine the extent to which current reforms, such as the European Market Infrastructure Regulation (EMIR) and the proposed Markets in Financial Instruments Directive (MiFID II) and Regulation (MIFIR), will expand 'public' securities and derivatives markets, while correspondingly reducing the scope of 'private' markets (which broadly coincide with the 'unregulated' over-the-counter markets). We also ask whether these reforms will on the whole reduce systemic risks and transaction costs of securities and derivatives trading in Europe. For these purposes, we formulate conjectures that are partly based on the experience of past reforms in the area equity trading.

Keywords: financial markets, securities trading, derivatives, European securities regulation, European derivatives regulation, Markets in Financial Instruments Directive (MiFID), European Market Infrastructure Regulation (EMIR), public markets, private markets, central clearing house, trade repository

* The final version of this paper was published on 13(2) Journal of Corporate Law Studies 319 (2013), and available at http://www.ingentaconnect.com/content/hart/jcls/2013/00000013/00000002/art00004.
† Professor of Business Law and Capital Markets Law, University of Genoa – Law Department; Director of the Genoa Centre for Law and Finance; ECGI Fellow.
‡ Global Research Fellow, New York Univerisity School of Law; Senior Research Fellow, Genoa Centre for Law and Finance.

A. INTRODUCTION

The recent financial crisis generated a deep revision of the regulation of securities and derivatives markets, similar for extension to that occurred in other sectors of financial regulation, but different in substance, given the specific problems emerged in these markets during the financial turmoil.[1] This paper critically examines the extent to which current reforms are expanding the regulation of 'public' securities and derivatives markets – which include regulated markets (RMs), multilateral trading facilities (MTFs) and organized trading facilities (OTFs) – while reducing the scope of 'private' markets (which broadly coincide with the 'unregulated' over-the-counter markets). In particular, we analyse the post-crisis reforms of securities and derivatives trading undertaken by the European Union (EU), which are currently under way and consist of two pillars. The first, the European Market Infrastructure Regulation (EMIR), mainly responds to systemic stability concerns. The second, the Markets in Financial Instruments Directive (MiFID) Review – structured in two proposals, one for a new Directive (MiFID II), the other for a Regulation (MiFIR) – tries to optimize the transaction costs of securities and derivatives trading, while also taking systemic stability goals into consideration.

We examine these reforms from a public interest perspective,[2] critically assessing the extent to which they will likely reduce the systemic risks and the transaction costs of securities and derivatives trading. Given the novelty of the measures either adopted or proposed by the regulators, particularly with respect to non-equity trading (including derivatives), we formulate conjectures that are mainly based on the impact of similar reforms already occurred in the area of equity trading. In general, we identify the main trends of current reforms, which are grounded on a discrete preference for trading on organized venues and for transparency also in over-

[1] For an overview and critical analysis, see E Ferran, N Moloney, J Hill and J Coffee, *The Regulatory Aftermath of the Global Financial Crisis* (Cambridge University Press 2012); N Moloney, 'EU Financial Market Regulation After the Global Financial Crisis: 'More Europe' or More Risks?' (2010) 47 *Common Market Law Review* 1317.

[2] For a 'private interest' analysis of similar topics: G Ferrarini and N Moloney, 'Reshaping Order Execution in the EU and the Role of Interest Groups: From MiFID I to MiFID II' (2012) 13 *EBOR* 557.

the-counter (OTC) markets, and show their costs and benefits with respect to trading on private markets, which are informal and opaque. More specifically, we consider three questions: (i) should transparency be extended to a wider set of transactions? (ii) Should EU regulation pull a wider range of trading venues into the regulatory net? (iii) Should the OTC trading market be reduced? [3]

The first question is particularly relevant for non-equity markets. On one side, it reflects the shifting of some securities and derivatives trades to organized trading platforms which are subject to transparency requirements, i.e. to public markets; on the other, it implies that transparency requirements are extended to OTC non-equity trades, along the lines already followed by MiFID with respect to equity trading. This question was answered in the negative with respect to non-equity trades just before the financial crisis, when the policy conclusion was reached that no relevant market failure appeared to exist and justify regulatory intervention. However, the attitude of both authorities and market participants deeply changed after the crisis, also in light of the problems created by market opacity throughout the turmoil. EMIR took a clear position in this regard extending its post-trade transparency requirement – i.e. mandatory trade reporting to centralized trade repositories – to all derivative transactions.

The second question considers whether the scope of public securities markets should be expanded. We more specifically evaluate the movement from OTC transactions to trading venues and ask whether this trend increases the efficiency of the markets and reduces transaction costs.[4] The answer is particularly relevant for

---

[3] See N Moloney, 'The Legacy Effects of the Financial Crisis on Regulatory Design in the EU' in E Ferran et al., (n 1) 111 at 161. Similar questions are dealt with by the Final Report by the Technical Committee of IOSCO, *Unregulated Financial Markets and Products* (September 2009) 4, which recommends 'ways to redefine the perimeter of regulation and the scope of intervention by regulators'.

[4] As argued by RH Coase, *The Firm, the Market and the Law* (University of Chicago Press 1988) 8-9, markets are institutions that exist in order to reduce the cost of carrying out exchange transactions,

dark pools such as broker-crossing networks (BCNs), which presently do not fall under any of the MiFID's categories of trading venues. Indeed, BCNs have a 'discretionary' character, which precludes defining them as multilateral trading facilities for MiFID purposes (as further explained below). Moreover, BCNs generally do not act as dealers vis-à-vis their clients and therefore cannot qualify as systematic internalisers under current MiFID. In this context, the European Commission has proposed to introduce a new category of trading venue in MiFIR and MiFID II – the 'organized trading facility' (OTF) – subject to rules similar to those applicable to regulated markets and multilateral trading facilities. Needless to say, this proposal encountered the approval of part of the exchange industry, but also the opposition of investment intermediaries, particularly those active in the OTC market. However, the International Swaps and Derivatives Association – ISDA – gave its support to the new classification finding that OTF might also be fit for derivatives trading, and that the new flexibility and choice in trading venues foster competition and reduce trading costs.[5]

The third question asks whether the scope of OTC markets should be narrowed and is connected with the previous one, to the extent that the inclusion of BCNs and similar venues in the OTF category would correspondingly restrict the scope of OTC markets. A restriction of private markets would also derive from the proposed obligation in MiFID II to move the trading of certain OTC derivatives to

---

while exchange regulations 'exist in order to reduce transaction costs and therefore to increase the volume of trade'. See also JR Macey and M O'Hara, 'From Markets to Venues: Securities Regulation in an Evolving World' (2005) 58 *Stanford L Rev* 563.

[5] See ISDA, *ISDA Comment Paper on MiFID/MiFIR* (23.11.2011) 8-9 <http://www2.isda.org/attachment/Mzk4Mw==/ISDA%20MiFID%20Position%20Paper%20-%2023%20Nov%202011.pdf> accessed 28 May 2013; *Id*, *MiFID/MiFIR: The OTF and SI regime for OTC derivatives* (April 2012) 3-4 <http://www2.isda.org/attachment/NDM2Mg==/MIFID%20-%20SI%20and%20OTF%20comments%20-%20final%20-%20Apr%202012.pdf> accessed 28 May 2013. ISDA is however supporting the role played by single-dealer platforms in the OTC derivatives market, in the form of SI operating electronic trading platform, subject to appropriate pre-transparency rules. Concerning the OTF structure, ISDA is arguing against the banning on the use of proprietary capital by the OTF operation.

trading venues, along the lines agreed upon by the G20 countries at their 2009 Pittsburgh Summit. Here again, the exchange industry and possibly part of the intermediaries support a positive answer, while those firms which are more active in the OTC derivatives markets try to protect their rents from opaque trading of the relevant instruments.[6]

In the rest of this section, we better explain the dichotomy 'public markets' – 'private markets', which is commonly used in the US literature, but can be fruitfully adapted to the EU context; we briefly highlight the political economy of the reforms under consideration, even though our focus in the subsequent analysis will mainly be on public interest concerns; and we offer an overview of the rest of the paper's topics.

1. Public v. private markets

A broad distinction between these two types of markets can be drawn also for Europe. On one hand, public markets (or venues) are formal, multilateral (in that the venue brings together multiple third party orders), non-discretionary (trades are executed according to the venue's pre-set rules or parameters) and lit (trading orders/interests are disclosed to the market, both pre- and post- trade). On the other, private markets are informal, bilateral (trading is between the venue and the client), discretionary (access to the platform is at the venue's discretion) and dark (trading interest is not publicly disclosed).[7]

Public markets are associated with formal, organized venues, including traditional stock and futures exchanges, but also newer multilateral trading platforms. These venues are predominantly associated with lit trading: the market is informed of

---

[6] For an insightful view on OTC derivatives see: D Duffie, *Dark Markets: Asset Pricing and Information Transmission in Over-the-Counter Markets* (Princeton University Press 2012).
[7] See G Ferrarini and N Moloney (n 2) at 565.

levels of trading interests pre- and post-trade. This form of trading is price-setting as the disclosure of trading interest supports wider price formation. The price formation function typically leads to the imposition of extensive transparency rules, or rules which require the disclosure of pre-trade bid/offer prices and post-trade trade price, volume and time information. These venues are also, as systemically significant venues, typically subject to authorization, organizational, capital, and access rules.

Private markets are associated with investment firms (brokers) providing discretionary execution services OTC (or not on formal markets) to their clients. Orders from clients might be executed bilaterally by brokers against their proprietary order books or 'crossed' internally against other client orders, and so would not be routed by the broker to a multilateral exchange or other platform. OTC trading between brokers and clients has long been a feature of equity and derivatives markets in the EU and internationally.[8] Technological developments have, however, led to the development of automated broker execution services. Broker execution is typically regarded as a client-facing service, which arises from the traditional fiduciary duties imposed on investment firms with respect to their clients and from the related best execution obligation.[9] It is therefore functionally different to multilateral platform trading. As an investment service, it is typically regulated through conduct of business regulation.[10]

Private (OTC) derivatives markets faced an exponential growth in the last ten years and are characterized by highly customized transactions. Derivatives dealers are

---

[8] Eg IOSCO (n 3) 4.

[9] E.g., 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. See Committee of European Securities Regulators (CESR), *Technical Advice to the European Commission in the Context of the MiFID Review - Equity Markets* (2010) <http://www.esma.europa.eu/system/files/10_394.pdf>.

[10] 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 (n 8) 27.

used to operate in a highly opaque marketplace, without offering public information about size, exposure, and volume of transactions. Moreover, derivatives dealers and brokers tailor-make their contracts to fit customers' needs and requirement.

Between these two main market structures, we also identify halfway and mixed solutions depending on different regimes as to transparency and organizational requirements. Core characteristics of a 'public' market are its multilateral and formal structure and the non-discretional execution of transactions. The 'publicity' of the market can be, however, softened by requiring lower standards of transparency. In a similar case, we might speak of a 'semi-public' market. This concept applies to venues, which are organized as MTFs or regulated markets, but are only subject to post-trade transparency. Conversely, we define as 'semi-private' markets the OTC markets when their participants trade listed securities and are therefore subject to pre- and/or post-trade transparency requirements, even if the transactions take place in a 'private' setting. Moreover, we also define as 'semi-private' the OTC derivatives markets to the extent that they are subject to mandatory clearing under EMIR. In the following sections, we analyse how the post-crisis reforms of the financial systems rebalance the 'public' – 'private' divide in financial markets.

2. Political Economy of Post-crisis Reforms

Prior to the recent crisis, regulation in the securities and derivatives area was largely the product of interaction between two main interest groups: the exchange industry and the investment intermediaries.[11] Other interest groups, including issuers and investors, appeared to be less active, as particularly shown by the MiFID's formation,

[11] G Ferrarini and F Recine, 'The MiFID and Internalization' in G Ferrarini and E Wymeersch (ed), *Investor Protection in Europe* (OUP 2006) 235.

when the main provisions reshaping the EU securities markets were a battleground mainly for stock exchanges and investment intermediaries.

After the crisis, issuers and investors have become more engaged in the policy arena, whilst politicians have been more active in derivatives and securities markets' reform often taking a strong and publicly visible stance in favour of investor protection and financial markets stability.[12] As a result, new legislation has been promoted not only by interest groups exerting influence on politicians, but also by politicians independently. On one side they leverage, generally with the support of the media, on individual issues particularly salient for their voters, such as for instance executive compensation at financial institutions or – in the field of this paper – financial derivatives and more recently government bonds.[13] On the other, they try to re-establish the hierarchy in the regulation of financial markets, after a long period of public de-regulation and industry self-regulation, which led to a dangerous inconsideration of systemic interests.[14]

Regulators have had to address both macro and micro level issues.[15] From a systemic risk perspective and while dealing with macro level issues, regulatory reform is a reaction to systemic events and shocks, such as the financial crisis, and a

---

[12] D Skeel, *The New Financial Deal: Understanding The Dodd-Frank Act and its (Unintended) Consequences* (Wiley 2011); E Ferran 'Crisis Driven Regulatory Reform: Where in the World is EU Going?' in E Ferran et al. (n 1) 1 at 37.

[13] G Ferrarini and MC Ungureanu, 'Economics, Politics, and the International Principles for Sound Compensation Practices. An Analysis of Executive Pay at European Banks' (2011) 64 *Vanderbilt L Rev* 431.

[14] In the self-regulatory scenario an important role was played by ISDA, which acts as a private standard setting body for derivative transactions. The ISDA Master Agreement, with the related Protocols, was the only form of (soft, private) regulation for derivatives. On the role of ISDA as private regulator or private standard-setter body, see P Saguato, 'Private regulation in the credit default swaps market: the role of ISDA in the new regulatory scenario of CDSs' in F Cafaggi and GP Miller (eds), *The Governance and Regulation of International Finance* (Edward Elgar Publishing 2013) 32.

[15] See C Mayer and JN Gordon, 'The Micro, Macro and International Design of Financial Regulation' (2012) Columbia Law and Economics Working Paper No. 422 <http://ssrn.com/abstract=2047436> accessed 13 June 2013.

way of reducing the scope and impact of systemic risk.[16] Generally similar interventions focus on structural elements and are oriented to provide authorities with effective tools to supervise and control the markets and its participants. In the post-2008 crisis scenario, the EU adopted a systemic perspective to build the new infrastructural system for OTC derivatives – the EMIR –, where the mandatory central clearing of eligible OTC transactions moves in the direction of reducing systemic counterparty risks, and the mandatory reporting of all OTC derivatives allows regulators to monitor market's risks, exposures and dimensions.[17] On the other hand, when following a transaction costs analysis, regulators seek to reduce transaction costs in financial markets and promote liquidity in the trading of financial instruments, with the final object of creating a more efficient market. The MiFID review moves in this direction: increasing pre- and post-trade transparency and shifting OTC derivatives to trading venues, both push for a reduction in transaction costs associated with derivatives trading and for an increase of liquidity in such markets.

Moreover, the policy discussions on the main issues raised by the financial crisis have usually occurred at international level and led to globally agreed upon reforms that were often announced in the occasion of G20 summits.[18] As a result, the guiding principles for reforms are set internationally, amongst the G20 countries and in other international fora, such as the Financial Stability Board (FSB), while the implementation of those principles is left to regional and national legislators. This is true also for securities and derivatives markets regulation, the reform of which at EU

[16] On systemic risk in financial markets, see SL Schwarcz, 'Systemic Risk' (2008) 97 *Georgetown L J* 193.
[17] What emerged from the crisis was the almost complete absence of reliable data on effective exposure on the OTC markets.
[18] C Brummer, *Soft Law and the Global Financial System: Rule Making in the 21st Century* (New York, Cambridge University Press 2012).

level was deeply influenced by international proposals firstly advanced by the G20 2008 Summit in Washington and then adopted by the G20 2010 Summit in Seoul. Such international initiatives stress the importance of systemic and macro-level reforms, with specific emphasis on strengthening financial markets transparency and increasing the resilience and transparency of financial derivatives.[19] Similar proposals were further specified by the work and recommendations of the FSB on derivatives market reforms[20] and IOSCO on unregulated financial markets and products.[21]

3. Overview of the paper

In the rest of the paper, we firstly analyse the EMIR's main rules on financial infrastructures for OTC derivatives and how they mitigate systemic risk and increase market transparency. We show, in particular, how EMIR reshapes the OTC private markets by injecting elements of 'publicity', such as transparency for all derivative transactions, mandatory clearing of standardized derivatives and mandatory trading of certain derivatives on exchanges or other electronic platforms (section B). We secondly focus on the MiFID Review and its innovative elements, also analysing the role left to 'private' markets and/or mixed solutions (section C).[22] Then, we pass on to consider the MiFIR and MiFID II proposals with regard to equity and non-equity trading and to the transparency issues concerning the various types of markets

---

[19] With regard to derivatives markets, the private sector promoted the first initiatives to provide clarity and transparency into the OTC markets. ISDA and market participants decided to increase transparency in derivatives markets by reporting data on contractual counter-parties and market volume to a centralized organizations: the ISDA CDS Marketplace (<http://www.isdacdsmarketplace.com/>) and the Depository Trust & Clearing Corporation (<http://www.dtcc.com/>).

[20] FSB, *Implementing OTC Derivatives Market Reforms* (2010) <http://www.financialstabilityboard.org/publications/r_101025.pdf >.

[21] IOSCO (n 3).

[22] The American equivalent of the European reforms in the OTC derivatives markets is Title VII of the Dodd Frank Act, see The Dodd–Frank Wall Street Reform and Consumer Protection Act (Pub L No 111-203, HR 4173).

(section D), and critically analyse the same from various perspectives (section E). In section F we draw our conclusions.

B. OTC DERIVATIVES: INTERNATIONAL TRENDS AND EMIR

The 2008 crisis refocused the attention of politicians and regulators on financial markets. In their view, the crisis revealed the vulnerability of OTC markets to systemic shocks and showed the inability of the financial industry self-regulation to effectively assess systemic issues related to their activities.[23] Dealers and self-regulatory organizations (SROs) fuelled by aggressive deregulatory policies, while modelling effective market mechanisms to contain transaction costs and to provide sophisticated products, generated sub-optimal results in containing the externalities of their activities.[24] The opacity of OTC markets, which derived from a lack of transparency on positions and exposures, and the consequent uncontrolled spread at a systemic dimension of counterparty risk,[25] triggered the intervention of governments and international policymakers. Regulators blamed the markets and their main actors for being driven by purely selfish private interests and excessive moral hazard; for

[23] There is a vast debate around the role of OTC derivatives in the financial crisis. No doubt, OTC derivatives contributed to the spread of the crisis at systemic level, due to the intricate web of interconnections among the biggest derivatives dealers. 'Derivatives and CDSs did play a part in the global financial crisis, but they did not cause it': see B Masters, 'Derivatives in Crisis – Safeguarding Financial Stability' (2009) <http://ec.europa.eu/internal_market/financial-markets/derivatives/index_en.htm#conf_crisis> (accessed 28 April 2013); see also European Commission *Commission Staff Working Document – Impact Assessment Accompanying document to the Proposal for a Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories* (2010) 18-24 <http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/20100915_impact_assessment_en.pdf>. On the role of credit derivatives and CDSs in the financial crisis see RM Stulz, 'Credit Default Swaps and the Credit Crisis' (2010) 24 *J of Eco Perspectives* 73.

[24] On the trade-off between private and public ordering of OTC derivatives, see D Awrey, 'The Dynamics of OTC Derivatives Regulation: Bridging the Public-Private Divide' (2010) 11 *EBOR* 155.

[25] OTC derivatives markets have developed around few major dealers see following nt 30.

externalizing the costs of their activities to society; and for free-riding on their systemic positions and role ('too-big-to-fail').[26] Derivatives markets have been the battlefields of post-crisis international regulatory intervention.[27]

The derivatives pre-crisis scenario was characterized by the co-existence of public and private derivatives markets. Both in the US and the EU, commodities derivatives, futures and options were mainly exchanged on public markets, such as the Chicago Mercantile Exchange (CME) [28] and Eurex.[29] Buyers and sellers operated therefore in regulated and supervised markets, where standardized contracts were traded in a lit environment. However, starting from 2000, a group of global financial institutions – the so-called G15 –[30] have created a huge OTC market for financial derivatives, built upon highly customized bilateral transactions.[31] The financial crisis

[26] In the aftermath of the financial crisis prominent journalists published inquiry books on financial markets and their participants. Sorkin analyses the concept of too-big-too-fail as a determinant of moral hazard in financial institutions, AR Sorkin, *Too Big to Fail: The Inside Story of How Wall Street and Washington Fought to Save the Financial System and Themselves* (Viking 2009); Tett describes the exponential growth of credit derivatives markets, G Tett, *Fool's Gold – the Inside Story of J.P. Morgan and How Wall St. Greed Corrupted Its Bold Dream and Created a Financial Catastrophe* (Free Press 2009); Lewis depicts the inner weaknesses of these markets in the run-up to the crisis, M Lewis, *The Big Short – Inside* (The Doomsday Machine, Norton 2011).

[27] The academic literature and the publications by governmental and non-governmental think tanks on derivatives and the post-crisis regulation is vast. Among the many contributions: VV Acharya and M Richardson eds, *Restoring Financial Stability: How to Repair a Failed System* (Wiley Finance 2009); CM Baker, 'Regulating the Invisible: The Case of Over-the-Counter Derivatives' (2010) 85 *Notre Dame L Rev* 1287; Committee on Capital Markets Regulation, *The Global Financial Crisis: A Plan for Regulatory Reform* (2009) <http://www.capmktsreg.org/research.html> accessed 28 April 2013; R Kroszner and R Shiller, *Reforming U.S. Financial Markets: Reflections Before and Beyond Dodd-Frank* (The MIT Press 2011); Squam Lake Working Group on Financial Regulation, *Credit Default Swaps, Clearinghouses, and Exchanges* (July 2009) <http://www.cfr.org/financial-crises/systemic-regulator-financial-markets/p19256>; LA Stout, 'The Legal Origin of the 2008 Credit Crisis' (2012) 1 *Harvard Bus L Rev* 301; US Treasury, *The Department do the Treasury Blueprint for a Modernized Financial Regulatory Structure* (March 2008) <http://www.treasury.gov/press-center/press-releases/Documents/Blueprint.pdf>; U.S. Treasury, *Financial Regulatory Reform a New Foundation, Rebuilding Financial Supervision and Regulation* (2009) <http://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf>.

[28] <http://www.cmegroup.com/>.

[29] <http://www.eurexchange.com/exchange-en/>.

[30] The G15 are the largest derivatives dealers operating in the market. See D Mengle, 'Concentration of OTC Derivatives among Major Dealers' (2010) 4 ISDA Research Notes 2010 <http://www.isda.org/researchnotes/pdf/ConcentrationRN_4-10.pdf>

[31] S Das, *Traders, Guns and Money: Knowns and unknowns in the dazzling world of derivatives* (Pearson Education 2010); Bank of International Settlement, *Semi-annual Surveys, Positions in Global Over-the-counter (OTC) Derivatives Markets at end-December 2012* <http://www.bis.org/statistics/derstats.htm> accessed 11 March 2013. At the end-December 2012, the OTC derivatives reached a notional amount outstanding contracts of $633 trillion.

hit more severely and spread through the OTC markets, so that the media blamed derivatives for causing the whole financial collapse, while regulators decided to strongly intervene in order to restore stability, confidence and trust in the financial markets.[32]

1. International Guidelines and European Reforms

Due to the international and cross-border dimension of the OTC markets, the G20 and the FSB – representing the largest economies of the world – adopted international guidelines to provide a common and harmonized framework for national regulators to reorganize their financial systems.[33] The new architecture of derivatives markets is grounded on four pillars:

1) promotion of OTC derivatives standardization,

2) transparency through trade reporting to centralized trade repositories,

3) establishment of a central clearing system, and

4) trading on exchanges and electronic platforms.[34]

These are the four-cornerstones of the EU regulatory action. In implementing such guidelines, the EU decided to follow two paths: firstly, by adopting a new regulation on financial infrastructures – to build the new structural elements of the derivatives

[32] See G P Miller, *Trust, Risk and Moral Hazard in Financial Market* (Il Mulino 2011).

[33] The document the G20 Leaders agreed on expressly states:

> *'All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non- centrally cleared contracts should be subject to higher capital requirements. We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse.'*

See G20 Leaders Statement After Talks in Pittsburgh <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=auIe3UTJncpY> accessed 11 March 2013.

[34] FSB, *Improving Financial Stability, Report of the Financial Stability Board to the G20 Leaders* (2009), 1 <http://www.financialstabilityboard.org/publications/r_090925b.pdf>; FSB, *Implementing OTC Derivatives Market Reforms* (n 20).

markets; secondly, by reviewing the existing MiFID directive – to adjust the existing rules on trading venues.

The European debate around the post-crisis reforms started in October 2008 when the Commission appointed a '[h]igh-level group on financial supervision', chaired by Jacques de Larosière. Aiming to investigate the causes of the financial crisis in Europe and to set a new regulatory agenda 'to take the European Union forward',[35] the High Level Group published its recommendations at the beginning of 2009. Mr de Larosière, in his introductory remarks, stressed the importance of setting up mechanisms to tackle financial systemic risks, to reduce counter-cyclical amplifiers and to strengthen transparency. Following this initiative, the Commission adopted two communications in July and October 2009 taking a position on the OTC market.[36] In implementing the de Larosière recommendations and the FSB guidelines on 15 September 2010 after a highly participatory consultation phase,[37] the EU Commission published a draft regulation on 'OTC Derivatives, Central Counter-parties and Trade Repositories'. The Council of the EU, the European Commission and the European Parliament reached a political agreement on the final text on 9

[35] See The High-Level Group on Financial Supervision in the EU, *Report* (25 February 2009) 4 <http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf>. The report, while underlying the role of OTC credit derivatives in the crisis as an element which contributed to the spread of losses around the world's economies (they, 'which were supposed to mitigate risk, but in fact added to it', 9), recommended, in Recommendation 8, '[…] to: - simplify and standardize over-the-counter derivatives; - introduce and require the use of at least one well-capitalized central clearing house for credit default swaps in the EU; - guarantee that issuers of securitized products retain on their books for the life of the instrument a meaningful amount of the underlying risk (non-hedged)' 25).

[36] The first Communication, published on July 2009, Commission, 'Ensuring efficient, safe and sound derivatives markets' COM(2009) 332 <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52009DC0332:EN:NOT> accessed 12 April 2013, focuses on the role played by derivatives in the financial crisis, on their benefits and costs, and advances solutions to contain the identified costs. The second Communication of October 2009, Commission, 'Ensuring efficient, safe and sound derivatives markets: Future policy actions' COM(2009) 563 <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2009:0332:FIN:EN:PDF>, structures the policy and reform agenda the Commission intends to propose to tackle the shortcoming of the derivatives markets: opacity, systemic risk and counterparty risk.

[37] The Commission received – from public authorities, market participants and derivatives dealers – more than 200 responses on the consultation document concerning the new 'Derivatives and market infrastructure' <http://ec.europa.eu/internal_market/consultations/2010/derivatives_en.htm>.

February 2012 and the text was approved by the European Parliament in plenary sitting on 29 March 2012. Finally, on 4 July 2012, the European Parliament and Council adopted the Regulation on OTC Derivatives, Central Counterparties and Trade Repositories (known as EMIR)[38], which entered into force on 16 August 2012. According to the EMIR's provisions, the European Securities Market Authority – ESMA – proposed to the Commission nine between additional delegated regulations and implementing regulations, which were endorsed on 19 December, published in the Official Journal on 23 February 2013 and entered into force on 15 March 2013.[39]

---

38 See European Parliament and o Council Regulation (EU) No 648/2012 of the of 4 July 2012 on OTC derivatives, central counterparties and trade repositories <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32012R0648:EN:NOT>.

39 See Commission Delegated Regulation (EU) 148/2013 of 19 December 2012 supplementing Regulation (EU) 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories with regard to regulatory technical standards on the minimum details of the data to be reported to trade repositories [2013] OJ L52/1 [hereinafter Supp Reg n 1]; Commission Delegated Regulation (EU) 149/2013 of 19 December 2012 supplementing Regulation (EU) 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on indirect clearing arrangements, the clearing obligation, the public register, access to a trading venue, non-financial counterparties, and risk mitigation techniques for OTC derivative contracts not cleared by a CCP [2013] OJ L52/11 [hereinafter Supp Reg n 2]; Commission Delegated Regulation (EU) 150/2013 of 19 December 2012 supplementing Regulation (EU) 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories with regard to regulatory technical standards specifying the details of the application for registration as a trade repository [2013] OJ L52/25 [hereinafter Supp Reg n 3]; Commission Delegated Regulation (EU) 151/2013 of 19 December 2012 supplementing Regulation (EU) 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories, with regard to regulatory technical standards specifying the data to be published and made available by trade repositories and operational standards for aggregating, comparing and accessing the data [2013] OJ L52/33 [hereinafter Supp Reg n 4]; Commission Delegated Regulation (EU) 152/2013 of 19 December 2012 supplementing Regulation (EU) 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on capital requirements for central counterparties [2013] OJ L52/37; Commission Delegated Regulation (EU) 153/2013 of 19 December 2012 supplementing Regulation (EU) 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on requirements for central counterparties [2013] OJ L52/41 (all <http://eur-lex.europa.eu/JOHtml.do?uri=OJ:L:2013:052:SOM:EN:HTML>); Commission Implementing Regulation (EU) 1247/2012 of 19 December 2012 laying down implementing technical standards with regard to the format and frequency of trade reports to trade repositories according to Regulation (EU) 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories [2012] OJ L352/20; Commission Implementing Regulation (EU) 1248/2012 of 19 December 2012 laying down implementing technical standards with regard to the format of applications for registration of trade repositories according to Regulation (EU) 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories [2012] OJ L352/30; Commission Implementing Regulation (EU) 1249/2012 of 19 December 2012 laying down implementing technical standards with regard to the format of the records to be maintained by central counterparties according to Regulation (EU) 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories [2012] OJ L352/32 (all <http://eur-

In addition to the EMIR, the European Commission published a consultation on revising the Markets in Financial Instruments Directive (MiFID).[40] On 20 October 2011, the Commission published a proposal for Directive aimed to amend the original MiFID and a proposal for a Regulation (MiFIR – Market on Financial Instruments and amending Regulation on OTC derivatives, central counterparties and trade repositories).[41] Together, the three new legal documents will implement the FSB and the G20 principles at European level and will be the new regulatory framework for 'public' and 'private' financial markets.[42]

2. EMIR and the new rules for OTC markets

As already mentioned, the EU regulatory response to the financial turmoil has been twofold: building new financial infrastructures for OTC derivatives and fixing the existing rules on 'public' markets. EMIR aims at increasing transparency in the OTC market vis-à-vis regulators and reducing counterparty and operational risk.

The OTC markets, as 'private' markets, are characterized by opacity as to contractual counterparties, volumes and prices of transactions. Art 9 of EMIR brings light to the OTC market imposing reporting of all concluded, modified or terminated derivative transactions. Counterparties and central clearing-houses (CCPs) are required to report details of any concluded, modified or terminated derivative transaction (and any modification or termination of that contract) to a registered trade

lex.europa.eu/JOIndex.do?year=2012&serie=L&textfield2=352&Submit=Search&_submit=Search&ihmlang=en>).

[40] An extensive literature, N Moloney, *EC Securities Regulation* (2 ed, OUP 2008) 769-778 and Ferrarini and Recine (n 11).

[41] Both proposals <http://ec.europa.eu/internal_market/securities/isd/mifid_en.htm> accessed 21 June 2013.

[42] To have a picture of the current status of implementation of the G20 financial reforms guidelines see FSB, *OTC Derivatives Market Reforms - Fifth Progress Report on Implementation* (15 April 2013) <http://www.financialstabilityboard.org/publications/r_130415.pdf>.

repository within one working day of conclusion, modification, or termination.[43] Reporting obligations apply to all derivative transactions and to all counterparties, regardless of whether they are financial or non-financial entities, or whether the derivative has been concluded for hedging purposes in performing commercial or treasury finance activities, or whether the derivative has been CCP-cleared or non-CCP-cleared. Therefore all counterparties to any derivative contract have to submit all the required information, as fixed by ESMA, to an authorized trading repository.[44] In order to avoid duplications of information, CCPs and counterparties may agree that only one party will complete the reporting obligations or that the reporting can be delegated to a third entity for completion; however they still remain responsible for the content and the timing of the reporting. In addition to the trade repository reporting, both the CCP and the counterparties have to keep records of the derivative transactions concluded: the CCP for 10 years, and the counterparties for 5 years. With regard to the obligation to disclose details and elements of the derivative contract concluded between the parties, EMIR specifies that trade reporting does not integrate any breach of confidentiality, nor does it have to be considered in breach of any restriction on disclosure of information imposed by the contract.[45]

Trade repositories have to comply with a double level information disclosure regime.[46] With regard to the public and market participants, trade repositories have to

---

[43] Trade repositories are subject to stringent regulation: they have to be authorized and recognized by the ESMA – if operating in the EU, or by the SEC or the CFTC – if operating in the USA; they are also subject to business conduct rules and structural requirements.

[44] With regard to the content of the trade repository communication, ESMA moved for a standardization of data used to describe a derivative transaction, see Regulation laying down implementing technical standards with regard to the format and frequency of trade reports to trade repositories according to European Parliament and Council Regulation (EU) No 648/2012 of the on OTC derivatives, central counterparties and trade repositories <http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/121219_its_minimum-details-trade-repositories_en.pdf> [hereinafter EMIR].

[45]See art 9(4) EMIR (n 46). This is the only contract law prevision within the regulation and it applies directly in all European jurisdictions.

[46] See Supp Reg n 4 (n 41).

publicize aggregate data on OTC derivative transactions. The aggregation has to be conducted on three levels: firstly, on transaction volumes per derivative classes; secondly, on open positions per derivative classes; and thirdly, on value per derivative classes.[47] That information has to be made available to the parties and aims to provide a general sense and overview of the derivatives markets. Conversely, all data and information reported have to be accessible to ESMA, European central banks, and European Systemic Risk Board – ESRB. These authorities, with their express mandate for monitoring and preserving financial stability in the European Union, have inspection and monitoring rights on all transactions data, with no limitation.[48]

As for reducing counterparty risk and managing operation risk, EMIR requires financial and non-financial counterparties to clear eligible standardized OTC derivatives through registered central counter-parties (CCPs).[49] This general rule, however, has some exceptions and requires a few specifications. First, the regulation concerns two categories of entities: financial counterparties and non-financial counterparties. Financial counterparties are banks, investment firms, insurance companies, pension funds and private funds (eg hedge funds and private equity funds);[50] non-financial counterparties are defined in a residuary way, as any other firms ('undertakings') other than the financial ones. Second, not all standardized OTC derivatives have to be cleared, only the ones declared eligible to the clearing obligation by ESMA, in accordance with art 5(2)(a). Thus ESMA, in completing the

---

[47] The macro classes indicated by ESMA are: commodities, credit, foreign exchange, equity, interest rate and other.
[48] Art 3 of the Supp Reg. n 4 (n 41), foresees the right to have access to transactions data collected by a trade repository to the relevant authority of a third country that has entered into an international agreement with the EU.
[49] See art 4 EMIR (n 46). The multilateral netting and clearing activity has to be performed by an authorized or recognized CCP. Title III of EMIR contains the set of rules that regulates CCPs and their activities. CCPs have to be authorized or recognized – if already existing and operating in a third country – by the ESMA; CCPs have to keep a fixed minimum permanent and available capital; they are subject to corporate governance rules and transparency requirements.
[50] See art 1 (8), EMIR (n 46).

determination of the classes of OTC derivative contracts eligible for clearing, is responsible to assess three main factors: the level of standardization of the legal documentation[51] and of the operational process;[52] the volume and liquidity of the relevant class of OTC derivatives; and the availability of fair, reliable and generally accepted pricing information for the class of derivatives *de quo*.[53]

Moreover, EMIR identifies some derivative transactions which, because of the parties involved and because of the reasons underlying the contract, are not subject to clearing obligations and therefore will continue to be concluded bilaterally and over-the-counter. Non-financial counterparties have a special treatment: they go exempt from the clearing obligation whenever their position in OTC derivative contracts does not cross the clearing threshold fixed by ESMA in art 11 of the Supplementing Regulation on non-financial counterparties.[54] These thresholds take into account the gross notional value of specific classes of OTC derivatives, resulting from the sum of net positions and exposures. An important element in calculating this threshold is the exclusion of all derivatives concluded by a non-financial counterparty as a hedging tool in its commercial activity or treasury financial activity.[55] In other words, hedging OTC derivatives, for their special rationale and highly customized structure, do not count within the clearing threshold and therefore non-financial counterparties that

---

[51] Master netting agreements, definitions, standard terms, confirmations, etc.

[52] With operational process the regulation refers to automated post-trade processing and lifecycle event.

[53] See art 7, Supp Reg n 2 (n 41).

[54] See art 10 (1) EMIR (n 46), and art 11 Supp. Reg n 2 (n 41)

> *'The clearing thresholds values for the purpose of the clearing obligation shall be:*
> *(a) EUR 1 billion in gross notional value for OTC credit derivative contracts;*
> *(b) EUR 1 billion in gross notional value for OTC equity derivative contracts;*
> *(c) EUR 3 billion in gross notional value for OTC interest rate derivative contracts;*
> *(d) EUR 3 billion in gross notional value for OTC foreign exchange derivative contracts;*
> *(e) EUR 3 billion in gross notional value for OTC commodity derivative contracts and other OTC derivative contracts not provided for under points (a) to (d)'.*

[55] An example of a derivative concluded to hedge the risk connected to a commercial activity is the contract between a pasta producer and a financial institution, concerning the risk of fluctuation of the wheat prices. On the other hand, a derivative aimed to reduce treasury financing activity risk could be a credit default swap concluded between a mortgagor and a derivatives dealer against the risk of default of the mortgagee; or the derivative against fluctuation in currency exchange rate between a company that exports its products and a bank.

enter into them are exempted from mandatory clearing.[56] As a result, all OTC derivative contracts executed either between two financial counterparties, or between a financial counterparty and a non-financial counterparty, which cross the threshold at art 10(b), or between two non-financial counterparties which cross the threshold, are subject to the clearing obligation. In addition to the general exemptions fixed in EMIR, the regulation expressly exempts specific institutions as well as intra-group derivative transactions from mandatory clearing.[57] In designing such exemption, the EU regulator realized the necessity of keeping an OTC semi-private market – subject to new transparency rules – for bespoke derivatives executed to meet peculiar financial and non-financial risks.

Given that not all OTC derivative transactions are subject to mandatory clearing, counterparties of exempt transactions have, under art 11 of the EMIR, to put in place risk mitigation techniques in order to measure, monitor and mitigate counterparty credit risk and operational risk.[58] Counterparties are asked to mark-to-market on a daily basis the value of their exposure on derivative transactions, to post and segregate collaterals and to have enough capital to manage risk not covered by collaterals.

---

[56] See art 10 Supp Reg n 2, *supra* nt 40. ESMA included in the 'hedging tool' exemption not only the directly risk-related derivative (the contract with the same underlying asset and same settlement date as the risk being covered), but also two more techniques: proxy hedging (risk mitigation achieved through a contract with a different underlying asset, but with similar economic behaviour to the hedged one), and macro or portfolio hedging (where one or more non-financial counterparties enter into OTC derivative transaction – via a single entity – to hedge the overall risks related to its activity of to the group's activity); see Recital (17) EMIR (n 46).

[57] Art 1(4) *id* EMIR (n 46) lists a few entities that are exempted from the application of the Regulation: the ESCB – central banks, the Bank for International Settlement, the European Financial Stability Facility and the European Stability Mechanism, art 89 *id* foresees a temporary – 3 years – exemption from clearing obligation for pension scheme arrangements.

[58] Art 11 *id.*

3. Critical assessment of EMIR

EMIR built the perimeter walls of the reformed OTC derivatives markets: higher standardization, mandatory clearing for eligible contracts and mandatory trade reporting to repositories, all move in the direction of creating a more sound and resilient derivatives market. However, the partition walls of the new markets are still under construction, and with partial delay. ESMA is still working on many implementing norms, which should provide detailed regulation on several crucial aspects of OTC transactions and market infrastructures. Therefore, ours is an evolving regulatory scenario, where market participants move faster than regulators.

Pre-requisite of the new derivative markets reforms and a necessary step to reduce transaction costs is the contractual and operational standardization of transactions. In this regard, ESMA fixed the principles to evaluate the level of standardization of contracts,[59] while ISDA has actively promoted higher levels of standardization for OTC derivatives.[60] Legal terms have been further standardized, while operational and process structures have been homogenized and remodelled.[61] However, space is still left to customized and bespoke contracts. Given the risk of

---

[59] See the Supp Reg n 2 (n 41) art 7.1

> *'In relation to the degree of standardization of the contractual terms and operational processes of the relevant class of OTC derivative contracts, the European Securities and Markets Authority (ESMA) shall take into consideration:*
> *(a) whether the contractual terms of the relevant class of OTC derivative contracts incorporate common legal documentation, including master netting agreements, definitions, terms and confirmations which set out contract specifications commonly used by counterparties;*
> *(b) whether the operational processes of that relevant class of OTC derivative contracts are subject to automated post-trade processing and lifecycle events that are managed in a common manner according to a timetable which is widely agreed among counterparties.'*

[60] See <http://www2.isda.org/functional-areas/infrastructure-management/g20-objectives/g20-standardization-documents/> accessed 20 June 2013. As shown by the statistics, CDSs and interest rate swaps have been highly standardized.

[61] See ISDA activity to develop a standardized taxonomy (classification) for OTC derivatives, <http://www2.isda.org/identifiers-and-otc-taxonomies/> accessed 20 June 2013. See also ISDA and Bloomberg agreement regarding the publication of the ISDA, *2013 Standard Credit Support Annex (SCSA)* <http://www2.isda.org/news/isda-publishes-2013-standard-credit-support-annex-scsa> accessed 20 June 2013.

setting up too rigid a system built on mandatory standardization of all OTC contracts, regulators acknowledged the role of bespoke OTC derivatives as effective risk management tools. Indeed, similar derivatives keep the elasticity to fit specific risks and peculiar needs of counterparties.[62] Moreover, due to customization, they are not tradable on exchange, nor eligible for clearing,[63] despite being subject to specific rules aimed at managing and reducing counterparty risk.[64]

The second and necessary step, which is still missing, is the publication of the list of derivatives eligible for clearing. ESMA is responsible to determine what classes of derivatives are eligible for clearing on the base of their standardization and on the presence of sufficient liquidity and trading volume for the same. The relevant process is still pending and it is not easy to predict how it will end up. No doubt, interest groups, such as derivatives dealers, on one side, and the exchange industry, on the other, will be putting pressure on ESMA, which will have to strike a balance in its pursuit of the public interest. Moreover, the markets have already identified classes of contracts that will likely be covered by the forthcoming definition, such as for instance interest rate swaps and CDSs, which are already standardized and available for clearing in CCPs.

A bit clearer is the regulatory scenario as to TRs and CCPs. ESMA adopted detailed regulation fixing the necessary requirements for firms to be recognized as TRs and CCPs. At the moment, a couple of applications have been submitted to

---

[62] ISDA estimates the OTC non-cleared derivatives market will consist of four main portions: 1) non eligible to clearing OTC derivatives (cross-currency swaps, interest rate swaptions and options (caps, collars, floors), single-name credit default swaps and various types of equity and commodity swaps); 2) derivatives which lack liquidity because of their unique economic terms (currency denominations, maturities, underlying reference rates, etc.); 3) derivatives with not standardized legal and operational terms; 4) derivatives exempted from clearing. See ISDA, *Non-Cleared OTC Derivatives: Their Importance to the Global Economy* (13 March 2013) 3 <http://www2.isda.org/functional-areas/research/studies/>.
[63] Non-cleared OTC derivatives will continue to play an important role in many industries and in many areas of economic activity. They are used extensively by corporations, investment and pension funds, governments and financial institutions to run their operations and to manage risk, see ISDA (62) 3.
[64] See art 11 EMIR (n 46).

EMSA for the official recognition as TRs.[65] Similarly, more that ten CCPs are clearing all assets classes of derivatives in Europe.[66] Private initiatives have been faster than regulators. Immediately after the financial crisis, OTC derivatives markets participants began to report their trades to centralized entities. The ISDA Marketplace, created within the perimeter of the derivatives industry self-regulatory body, was the first entity to collect post-trade data on CDS transactions, making them available – in aggregate terms – to the public.[67] Private initiatives followed shortly, particularly when the Depository Trust & Clearing Corporation – DTCC – began to offer data collecting services – in addition to clearing services – for a vast segment of OTC derivatives.[68] This activity started in the US – where the company is based. Subsequently, trade repository services were offered in other geographical areas – such as the EU, Japan, Singapore, Hong Kong, etc – while the DTCC's official role as a global trade repository was confirmed by ISDA in 2013.[69] Last available data shows that '18 TRs are either registered or are in the process of becoming registered' and they 'could accept reporting across all five major asset classes'.[70] At mid-2012, the almost totality of interest rate and credit derivatives were reported to TRs.[71]

---

[65] With regard to TRs see <http://www.esma.europa.eu/page/Trade-repositories> accessed 25 June 2013. At July 1, DTCC applied for the TR license in Europe – serving all classes of derivatives see <http://www.dtcc.com/products/derivserv/suite/global_trade_repository_for_otc_derivs.php> access 1 July 2013, as well as CME see <http://www.thetradenews.com/news/Regions/Europe/CME_applies_for_European_trade_repository_licence.aspx> accessed 1 July 2013.

[66] Concerning CCPs' activity in the EU, see FSB (n 42) 64-67.

[67] See ISDA CDS Market Place, one of the first public and free platform to provide data on CDSs markets, see <http://www.isdacdsmarketplace.com/> accessed 1 July 2013

[68] See DTCC <http://www.dtcc.com/products/derivserv/index.php> accessed 1 July 2013

[69] See <http://www.dtcc.com/products/derivserv/suite/global_trade_repository_for_otc_derivs.php> accessed 1 July 2013.

[70] See FSB (n 42) 19-21. The five major asset classes of OTC derivatives – for the purpose of the FSB Report – are interest rate, credit, commodity, FX and equity.

[71] See FSB (n 42) 21; almost 97% of interest rate OTC derivatives and around 99% of credit derivatives were reported.

The scenario is slightly different as to central clearing.[72] The potential high implementation costs for markets participants – such as the capital requirements for the CCP and its participants – keep the clearing market into smaller, but growing dimensions. So far, existing clearinghouses have extended their clearing services to new classes of OTC derivatives. As of end-February 2013, around 40% of the total outstanding interest rate derivatives and 30% of outstanding credit derivatives were cleared.[73]

C. THE MIFID REVIEW

We pass on to analyse the main aspects of the MiFID Review concerning trading venues and transparency regimes. After examining CESR's Technical Advice and the European Parliament summer 2010 Resolution, we consider the Commission's Consultation on the MiFID Review also in light of the CESR 2009 Report on non-equity transparency.

[72] The academic debate around the role of CCPs in the re-shaped derivatives markets is vast. Starting point of the debate is the assumption that 'effective clearing mitigates systemic risk by lowering the likelihood that defaults propagate from counterparty to counterparty', see D Duffie and H Zhu, 'Does a Central Clearing Counterparty Reduce Counterparty Risk?' (2011) 1 *Review of Asset Pricing Studies* 74. Around this statement, scholars assumed different positions. For a critical approach see M Roe, 'Systemic Cost of Derivatives Priority' (2011) 63 *Stanford L J* 587, who stressed the risk that the clearing mechanisms would not mitigate systemic risk, but simply concentrate all risks in a too-big-to-fail entity. D Duffie and H Zhou, *id*, argue in favour of clearing as a efficient netting and system risk mitigation mechanism when it is performed by 'joint clearing of standard interest rate swaps and credit default swaps in the same clearing house'. For a costs and benefits analysis of OTC derivatives clearing see C Pirrong, 'The Economics of Central Clearing: Theory and Practice' *ISDA Discussion Papers Series 1* (May 2011) <www2.isda.org/attachment/...==/ISDAdiscussion_CCP_Pirrong.pdf>.

[73] See FSB (n 42) 33-37.

1. CESR and the European Parliament

The opening salvo in the MiFID Review came with CESR's July 2010 Technical Advice to the Commission.[74] With respect to RMs and MTFs,[75] CESR recommended that the MiFID pre-trade waiver system, which supports RM/MTF dark pools, remain in place and that Member State discretion over its operation be retained. But suggesting some concern with the current dark pool regime, 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 ESMA empowered to monitor the pre-trade regime and to propose related technical standards. It also recommended that RM and MTF requirements be aligned to the more prescriptive RM standards and 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. In addition, CESR 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.

With respect to the OTC markets, CESR noted the 'considerable debate' on the size of these markets and the need to establish a factual basis.[76] It also recommended that a tailored regime apply to firms operating BCSs – defined as internal electronic matching systems operated by an investment firm that execute

---

[74] *Id* (n 42). See G Ferrarini and N Moloney (n 2) 581.
[75] Only those elements of CESR's Advice which are relevant to this discussion are covered.
[76] FSB*, supra* nt *42,* 27.

orders against other client orders or house account orders.[77] More controversially, CESR, drawing heavily and problematically[78] on the US Alternative Trading System model,[79] 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.

The path to MiFID's reform was accelerated by the European Parliament with a summer 2010 Resolution[80] which 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.[81] The Resolution was generally hostile to the fragmented post-MiFID landscape and to OTC trading. 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. It 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,

---

[77] *Ibid* CESR proposed rules addressing: 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.

[78] The 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.

[79] CESR/10-394 (n 9) 27-28. Although CESR noted the differences between the EU and US regulatory systems.

[80] European Parliament, *Resolution of 15 June 2010 on derivatives markets: future policy actions* (A7-0187/2010) <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P7-TA-2010-0206+0+DOC+XML+V0//EN >. The Resolution followed a summer 2010 'fact-find' on dark trading; ECON Dark Pool Workshop, *European Parliament, ECON Committee, Trading in Financial Instruments – Dark Pools. Workshop Summary, 2010 (the ECON Dark Pool Workshop), Deutsche Börse presentation* (2010) <http://www.europarl.europa.eu/RegData/etudes/divers/join/2010/440286/IPOL-ECON_DV(2010)440286_EN.pdf>

[81] Eg JR Macey and M O'Hara, 'From Markets to Venues: Securities Regulation in an Evolving World' (2005) 58 *Cornell L Rev* 563.

such that BCSs carrying out functionally-equivalent activities to SIs, MTFs, and RMs, were regulated as such and called for a related notification system. Also, it supported the alignment of the RM and MTF regime already suggested by CESR's July Technical Advice to the Commission. More radically, but vaguely, it called for reforms which would lead to a substantial decline in OTC trading.

2. The Commission Consultation

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). 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 with respect to data quality, RM/MTF alignment, and RM/MTF waivers.[82]

[82] CESR recommended that RM and MTF requirements be aligned to the more prescriptive RM standards and 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. Its largely uncontested post-trade recommendations were designed to address the concerns as to the quality of post-trade information which had 'deteriorated significantly'. CESR/10-394 (n 8) 16. CESR also recommended that new standards address the quality 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

The market response to the Commission Consultation, which was massive in scale,[83] was generally hostile, both from the trading platform/exchange and the OTC sectors. Most difficulties arose concerning the new OTF classification. Criticisms from the OTC sector, at 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 core functionality, the danger 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.[84] 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.[85]

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,[86] warned that there was no 'right-size' of OTC market,[87] and called for greater understanding of the nature and scale of OTC

Tape of transparency information, which would be developed by the industry, within a MiFID framework and time-frame.

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

[84] Variously Deutsche Bank, AFME, Goldman Sachs International, ICMA and BBA Responses to the December 2010 Commission Consultation.

[85] Eg FESE Response to Commission December 2010 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.

[86] Deutsche Bank Response to Commission December 2010 Consultation.

[87] AFME Response to Commission December 2010 Consultation.

trading.[88] 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.[89]

3. Transparency of Non-equity Markets

The Consultation also addressed non-equity markets, along the lines already suggested by CESR in its 2009 Report on the transparency of bond and derivatives markets.[90] This Report responded to some of the recommendations made by the 2008 FSF Report which analysed the likely causes and weaknesses of the financial turmoil that broke out in the summer of 2007 in view of recommending tools for increasing the resilience of markets and institutions.[91] Recommendation III.13 of the FSF Report relates to post-trade transparency in secondary markets, asking securities markets regulators to work with market participants in view of setting up 'a comprehensive system for post-trade transparency of the prices and volumes traded in the secondary markets for credit instruments'.

The 2009 CESR Report is divided in two parts, one dedicated to corporate bonds and the other to structured finance products and credit derivatives. The first part proceeds from an analysis of market failures in the corporate bond market during the recent crisis, also reporting on the outcomes of a consultation conducted by CESR on these issues. Indeed, from summer 2007 onwards the corporate bond markets suffered from a severe retreat of liquidity accompanied by the widening of bid-offer spreads, reduced availability of information and difficulties in valuing positions.[92]

---

[88] *Ibid.*
[89] Eg FESE Response and Nasdaq OMX Response to Commission December 2010 Consultation.
[90] CESR/09-348, *Transparency of Corporate Bond, Structured Finance Product and Credit Derivatives Markets* (2009).
[91] Financial Stability Forum (FSF), *Enhancing Market and Institutional Resilience* (2008).
[92] CESR/09-348 (n 8) 13.

Nonetheless, the interpretations of these circumstances varied amongst respondents to the consultation, with some (generally the sell side representatives) defining the same as a natural reaction to the crisis given the lack confidence between market participants. Others (both buy side respondents and exchanges) argued that similar circumstances represented a market failure reflecting concerns over exposure risk and uncertainty on valuations.[93]

However, most of the responses confirmed the existence of information asymmetries between retail and wholesale investors – as already found by CESR 2007 Report – adding that the financial crisis had extended the information asymmetries to some institutional investors which experienced great difficulties in valuing corporate fixed income assets in their portfolios. CESR, on its part, argued that 'a lack of post-trade transparency does not appear to be one of the main reasons for the decline in liquidity' during the financial crisis, as there were several other reasons for the widening of bid-offer spreads. However, 'greater post-trade transparency might have provided greater certainty around prices during the crisis which in turn might have had a positive impact on liquidity, although it is difficult to quantify the extent of any impact'.[94] CESR concluded recommending an increased level of transparency for corporate bond markets, provided that the new requirements were carefully calibrated to minimise any negative impact on liquidity.[95]

The second part of CESR Report concerns structured finance products and credit derivatives. The discussion about the need for additional transparency in the relevant markets covers a number of key aspects, such as the transparency of the underlying assets (eg the underlying mortgages in a mortgage-backed security) or of the structure of the product; trade transparency; position transparency (i.e. firm

---

[93] *Ibid* 27.
[94] *Ibid* 28.
[95] *Ibid* 30.

specific information about the positions held in certain products provided to supervisors for prudential supervision or market monitoring purposes); transaction reports; general market information (as to the sixe, liquidity, bid/offer spreads etc).[96] The Report focuses on trade transparency, while acknowledging the interaction between the different types of transparency.[97] It also acknowledges that the securitised and credit derivatives markets are overwhelmingly institutional, but underlines that before the recent crisis even retail investors (mostly high net worth individuals) had invested in structured products. CESR's conclusion however is that post-trade information has a role to play in these markets, even though the lack of similar information may not have been the key reason behind the recent market turmoil. In any case, the appropriate level of transparency should be calibrated with respect to the relevant instruments, their trading methods and types of market participants.[98] In particular, regard should be paid to the need to minimize any potential drawback of post-trade transparency on liquidity by allowing delayed publication and/or disclosure of trade without indication of the precise relevant volume of transactions exceed a given threshold.[99]

Following CESR's path, the Commission's Consultation Document argued that existing price and market data reporting tools for non-equities are not always considered sufficient, for prices often depend on the willingness of dealers to provide investors with quotes on request through electronic or telephone channels and enter into trades with them. Whilst admitting that the balance between transparency and liquidity is hotly debated for non-equities, the Commission suggested that the principles of the MiFID transparency regime for shares could be adopted, save for

---

[96] *Ibid* 42.
[97] As described in sections B.2, B.3, transparency vis-à-vis regulators in the derivatives markets has been address by EMIR.
[98] *Ibid* 47.
[99] *Ibid* 49.

tailoring the detailed requirements to the specificities of the different non-equity asset classes. In particular, the Commission suggested that MiFID should be amended to require pre- and post-trade transparency for all trades in specific non-equity products, whether executed on regulated markets, MTFs, organized trading facilities or OTC. This requirement would apply to all bonds and structured products for which a prospectus has been published or which are admitted to trading either on a regulated market or MTF.

D. THE MIFIR AND MIFID II PROPOSALS

The Commission's MiFID Review proposals were published on 20 October 2011 and followed the main themes established by the MiFID Consultation. The proposals develop as a two-peaks system. The first peak, the MiFID II Directive proposal, sets out the authorization and operating rules, which apply to investment firms and RMs;[100] the second peak, the Regulation proposal (MiFIR proposal), addresses the transparency regime and focuses on the trading of OTC derivatives on trading venues.[101] Starting from 2011, the proposed pieces of legislation have followed consultation and modification procedures between European Regulators and market participants, and within the European institutions themselves. On 19 June 2013, the Irish Presidency of the Council of the EU published the final version of the MiFIR[102]

[100] See Council Proposal COM(2011)/0298 for a Directive of the European Parliament and of the Council on markets in financial instrument repealing Directive 2004/39/EC of the European Parliament and of the Council (October 2011) [hereinafter MiFID II proposal].
[101] See Council Proposal COM(2011) 652 Proposal for a Regulation of the European Parliament and of the Council on markets in financial instruments and amending Regulation [EMIR] on OTC derivatives, central counterparties and trade repositories (October 2011) [hereinafter MiFIR proposal].
[102] See Council Proposal 2011/0296(COD) - 11007/13 Proposal for a Regulation of the European Parliament and of the Council on markets in financial instruments and amending Regulation [EMIR] on OTC derivatives, central counterparties and trade repositories (18 June 2013)

and MiFID II[103] proposals, to be considered by the European Parliament in its plenary session to be held from 9 to 12 December 2013. The MiFIR Proposal in particular reflects the movement towards a 'single EU rule-book' post-crisis, and is designed to 'establish uniform requirements' (art 1), although both MiFID II and MiFIR are characterized by reliance on detailed delegated rules and ESMA's involvement.

1. A wider regulatory perimeter

The Commission suggested that 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 had '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.'[104]

In support of this objective, and at the core of the MiFID Review proposals, is the concern to extend the regulatory perimeter around trading venues to encompass a wider range of venues, and to apply the same set of rules to this wider set of

---

<http://register.consilium.europa.eu/pdf/en/13/st11/st11007.en13.pdf> [hereinafter Final MiFIR proposal]

[103] See Council Proposal 2011/0298(COD) - 11006/13 Proposal for a Directive of the European Parliament and of the Council on markets in financial instrument repealing Directive 2004/39/EC of the European Parliament and of the Council (18 June 2013) <http://register.consilium.europa.eu/pdf/en/13/st11/st11006.en13.pdf> [hereinafter Final MiFID II proposal].

[104] MiFIR proposal (n 101) 2-3.

venues.[105] A driving concern appears to be the 'future proofing' of MiFID against future changes to the nature of organized trading and to address current and potential regulatory arbitrage risks.[106] 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'.[107] The SI regime is to be retained, but clearer and more detailed rules will apply, designed to distinguish clearly SI trading from OTC trading.[108] A new 'SME growth market' is to be introduced as a sub-category of MTF characterised by the fact that the majority of issuers whose financial instruments are admitted to trading are small and medium-sized enterprises, along the model of existing SME markets.[109] An operator of a similar market would be entitled to apply to have the MTF also registered as an SME growth market, if it meets certain conditions.[110] The Commission shall be empowered to adopt delegated acts further specifying these requirements. The measures shall take into account the need for the requirements to maintain high levels of investor protection and to promote investor confidence in those markets, while minimising the administrative burdens. The registration of these markets should raise their visibility and profile and help lead to common pan-European regulatory standards for such markets, that are tailored to take into account

[105] See G Ferrarini and N Moloney (n 2) 586.
[106] MiFIR proposal (n 101) 7, and Final MiFIR proposal recital 3, *supra* nt 102.
[107] Final MiFIR proposal (n 102) recital 6.
[108] MiFIR proposal (n 101) 9-10 and Final MiFID II proposal (n 102) arts 13-20.
[109] Final MiFID II proposal (n 103) art 35 (1).
[110] Final MiFID II proposal (n 103) art 35 (3). The SME growth market rules should e.g. set appropriate criteria for admission to trading of financial instruments; require that sufficient information is published to enable investors to make an informed judgment about whether or not to invest in those instruments; require ongoing periodic financial reporting by or on behalf of an issuer on the market; make the Market Abuse Regulation applicable to issuers on the market and persons discharging managerial responsibilities in the issuer.

the needs of issuers and investors in these markets while maintaining existing high levels of investor protection.

The most radical proposal, however, is the new OTF regime, which reflects the earlier December 2010 Commission 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.[111] Investment firms and market operators operating trading venues will be subject to identical transparency regimes, and to 'nearly identical' organization and market surveillance rules.[112] 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. While the new regime is designed to treat RMs, MTFs, and OTFs similarly – the definition of 'trading venue' means in fact any RM, MFT or OTF –[113], it nonetheless assumes one key difference, which has significant implications for the coherence of the regime. It assumes that the operators of RMs, MTFs, and OTFs are all neutral, but that RMs and MTFs (reflecting the MiFID classification rules) offer non-discretionary order execution, and non-discretionary access. Reflecting the origin of OTF systems in bilateral trading, OTF operators, however, 'should carry out order execution on a discretionary basis subject' and can route orders to other venues, and can control access to their execution systems.[114] They should accordingly be subject

---

[111] Final MiFIR proposal (n 102) Recital 7. OTFs include '*broker crossing systems, which can be described as internal electronic matching systems operated by an investment firm which execute client orders against other client orders. The new category also encompasses systems eligible for trading clearing-eligible and sufficiently liquid derivatives. It shall not include facilities where there is no genuine trade execution or arranging taking place in the system, such as bulletin boards used for advertising buying and selling interests, other entities aggregating or pooling potential buying or selling interests, electronic post-trade confirmation services, or portfolio compression, which reduces non-market risks in existing derivatives portfolios without changing the market risk of the portfolios.*'
[112] Final MiFIR proposal (n 102) 7.
[113] Final MiFIR proposal (n 102) art 2.1(25).
[114] Final MiFIR proposal (n 102) recital 8.

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.[115]

An OTF is defined as a multilateral system or facility which is not regulated as an RM or MTF, which is operated by an investment firm or market operator, and in which multiple third party buying and selling interests in financial instruments are able to interact in a way which results in a contract.[116] OTF operators will, 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. The OTF operator will also 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 will 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).[117] The Consultation proposal that OTFs convert to MTFs when trading volume reach particular thresholds was not pursued. A last critical point about the proposed OTF regimes concerns the asset classes to be included in an OTF. The Council and the European Parliament are in fact standing on opposite positions: the former pushes to have all asset classes within the definition of OTF, the latter insists on removing equity from the OTF perimeter. The lobbying battlefield is still active: the stock exchange industry is backing the Parliament's position, arguing that 'all inclusive' OTF will reduce investor protection, will allow BCNs to offer 'preferential treatment to certain clients', and will reduce 'the availability for small and medium enterprises to raise capital in the EU', because of the potential higher

[115] Final MiFIR proposal (n 102) 7 and recital 8.
[116] Final MiFIR proposal (n 102) art 2(1)(7).
[117] Final MiFID II proposal (n 103) arts 18-20.

regulatory costs. While many banks, in support of the Council's proposal, support the establishment of all assets classes OTF as increasing competition and quality of trading. [118]

2. Equity and Non-equity Transparency Requirements

The MiFIR Proposal 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.[119] ESMA would also be charged with monitoring the application of post-trade deferrals by national competent authorities.[120] The new regime will also apply to equity-like instruments (including exchange-traded funds and depositary receipts). [121] The SI pre-trade regime will be significantly clarified and tightened.[122] All OTC venues (including SI) will be subject to post-trade transparency obligations.[123]

The MiFIR Proposal also includes rules on transparency for non-equity instruments, based on the premise that 'the financial crisis exposed specific

[118] See Philip Stafford, 'EU agrees breakthrough in market rules' *Financial Times* (London, 13 June 2013). The Council, under the Irish presidency, is expecting to reach a final agreement with the European Parliament by the end of the year, before the end of its mandate.
[119] Final MiFIR proposal (n 102) arts 4-4(a). The Council '[i]n order to avoid any negative impact on the price formation process […] introduce[d] an appropriate volume cap mechanism for orders placed in systems which are based on a trading methodology by which the price is determined in accordance with a reference price and for certain negotiated transactions', see recital 14(a) Final MiFIR Proposal supra nt 102. Such provision allows the execution of transactions in dark pools, but using prices formed and disclosed in lit venues. More specifically the waivers refer to the following caps:
'i) the percentage of trading in a financial instrument carried out on a trading venue under these waivers shall be limited to 4% of the total volume of trading in that financial instrument on all trading venues across the Union over the previous 12-month period.
ii) overall EU trading in a financial instrument carried out under these waivers shall be limited to 8% of the total volume of trading in that financial instrument on all trading venues across the Union over the previous 12-month period.' See art 4(a)1 Final MiFIR Proposal (n 102).
[120] Final MiFIR proposal (n 102) art 20(3), (4).
[121] Final MiFIR proposal (n 102) arts 3-6.
[122] Final MiFIR proposal (n 102) arts 13-16.
[123] Final MiFIR proposal (n 102) arts 9, 20.

weaknesses in the way information on trading opportunities and prices in financial instruments other than shares is available to market participants, namely in terms of timing, granularity, equal access, and reliability'[124]. The proposed rules would introduce a transparency regime in markets for bonds, structured finance products and derivatives so as to help the valuation of products and the efficiency of price discovery.[125] Reducing the extent of the original Consultation document by the Commission, the new pre-trade and post-trade transparency obligations would cover all bonds, structured finance products, and derivatives traded on RMs, MTFs or OTFs – i.e. trading venues.[126] As a result, 'only those financial instruments traded purely OTC which are deemed particularly illiquid or are bespoke in their design would be outside the scope of the transparency obligations'.[127] As for shares, the same pre- and post-trade transparency requirements should apply to the all types of venues, but the transparency requirements should be calibrated for different types of instruments and types of trading (electronic and voice, order-book and quote driven systems).[128]

Focusing on OTC derivatives, MiFIR calibrates differently pre- and post-trade transparency requirements. As already mentioned, art 7 imposes pre- trade transparency on all 'derivatives traded on a trading venue' by requiring trading venues to make public the 'current bid and offer prices of trading interests at those

[124] MiFIR proposal (n 101) recital 12.
[125] Final MiFIR proposal (n 102) recital 13.
[126] Final MiFIR proposal (n 102) arts 7, 20. The new version of art 20 of the final MiFIR proposal, limits post-trade transparency to '[i]nvestment firms which, either on own account or on behalf of clients, conclude transactions in bonds, structured finance products, emission allowances and derivatives traded on a trading venue shall make public the volume and price of those transactions and the time at which they were concluded. This information shall be made public through an APA.'
[127] Final MiFIR Proposal (n 102) recital 18, 'It is not the intention of this Regulation to require the application of pre-trade transparency rules to transactions carried out on an OTC basis, the characteristics of which include that they are non-systematic, ad-hoc, irregular and infrequent, are carried out between eligible or professional counterparties, and are part of a business relationship which is itself characterised by dealings above standard market size, and where the deals are carried out outside the systems usually used by the firm concerned for its business as a systematic internaliser.'
[128] Final MiFIR proposal (n 102) arts 3, 5.

prices which are advertised through their systems'.[129] As for equity instruments, the proposed Regulation provides for a safety valve, by granting competent authorities – read ESMA and national authorities – the power to waive pre-trade transparency obligation on the base of 'the market model, the characteristics of trading activity in a product and the liquidity'.[130]

Moving on to post-trade transparency, all OTC derivatives whether or not eligible for clearing or trading, are subject to post-trade reporting to centralized repositories under art 9 EMIR. Art 9 and 20 of MiFIR proposal require regulated markets, investment firms and markets operators operating a trading venue to comply with post trading disclosure of the volume, price and time of the derivative transactions traded on the venue. Such a provision has to be coordinated with the reporting obligations fixed in art 9 EMIR. The gap between the two transparency regimes is quite large, even larger after the last modifications of the proposal made by the Council. Reporting obligations under EMIR are now much broader than the post-trade disclosure requirement under MiFIR. The structural difference between the two sets of transparency provisions reflects the two rationales for regulatory intervention: systemic versus transactional level. On one side, due to systemic concerns, mandatory reporting under EMIR extends to all counterparties and CCPs, and to all concluded, modified and terminated derivative contracts, no matter whether they are standardized, cleared or traded. It is a 'one size fits all' requirement. On the other, transparency under MiFIR operates as a tool to reduce transaction costs and market abuse, and therefore it is limited to derivatives traded on trading venues. Pre-trade and post-trade transparency, in fact, do not cover pure OTC derivatives because of their

[129] Final MiFIR proposal (n 102) art 7.
[130] Final MiFIR proposal (n 102) recital 11 and art 8, waivers should be granted for: '[…] a) orders that are large in scale compared with normal market size and orders held in an order management facility of the trading venue pending disclosure; […] d) orders that are large in scale compared with normal market size and orders held in an order management facility of the trading venue pending disclosure'

illiquidity and their high level of customization.[131] MiFID II proposals also address data publication and consolidation in some detail, reflecting CESR's original model.

3. Obligation to Trade Derivatives on Trading Venues

The MiFIR Proposal includes an obligation to trade certain derivatives on RMs, MTFs or OTFs, reflecting the agreement reached by the parties to the G20 Pittsburgh summit on 25 September 2009 to move trading on standardized OTC derivative contracts, which are not intragroup transactions, to exchange or electronic trading platforms where appropriate.[132] This agreement foresaw that a formal regulatory procedure should be defined for mandating trading between financial counterparties and large non-financial counterparties in all derivatives that are clearing-eligible[133] and sufficiently liquid for being traded on a trading venue.[134] The agreement required to move trading on standardized OTC derivatives to either exchanges or electronic trading platforms where appropriate, so that a suitable range of eligible venues should be provided given the lower liquidity of various OTC derivatives.[135] Interestingly, the MiFIR Proposal assigns wide regulatory powers to ESMA, which would be asked to develop draft implementing technical standards to determine which class of derivatives (subject to clearing obligations) should be traded on RMs, MTFs, OTFs or third country trading venues, and the date from which the trading obligation takes effect.[136] In developing these standards, ESMA shall consider the relevant class (or subset) of derivatives sufficiently liquid on the basis of criteria such as the average

[131] As stated in Final MiFIR Proposal recital 9 (n 102) 'all organised trading should be conducted on regulated venues and be fully transparent, both pre and post trade. Transparency requirements therefore need to apply to all types of trading venues, and to all financial instruments traded thereon.'
[132] Final MiFIR Proposal, arts 24-27 and recital 21 (n 102).
[133] Final MiFIR Proposal art 24(1) (n 102).
[134] Final MiFIR Proposal, recital 21 (n 102).
[135] Final MiFIR Proposal, recital 22, 22(a), 23 (n 102).
[136] Final MiFIR Proposal, art 26(1) (n 102).

frequency and average size of trades, and the number and type of active participants.[137]

E. CRITICAL ASSESSMENT OF THE MIFIR AND MIFID II PROPOSALS

In order to critically assess the MiFID Review and the relevant proposals, we separately consider equity trading, the new OTF category, and the regulatory perimeter for non-equities.

1. Equity Trading

There is much to commend in the MiFID II and MiFIR proposals for equity market trading.[138] The tightening of the pre-trade transparency regime for RMs/MTF waivers should bring greater consistency across EU markets. The post-trade transparency proposals, designed to improve data quality and support consolidation, 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 and limit opportunities for gaming.

Moreover, the OTC trading sector is not without regulation under MiFID. Post-trade rules apply to all OTC equity trades (relative to instruments traded on a trading venue)[139], as do the general rules concerning organizational and conduct of business regulation which apply to investment firm trading. It is also clear that MiFID, from a policy perspective, supports and provides for limited dark trading. Dark trading is supported through the MTF/RM transparency waiver system which

[137] Final MiFIR Proposal, art 26(3) (n 102).
[138] See G Ferrarini and N Moloney (n 2) 588.
[139] Final MiFIR Proposal, art 19, *supra* nt 102.

allows semi-public markets, as 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 general treatment of the OTC sector as a dark market pre-trade.[140] 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 or subject to detailed waiver rules where dark, and where related 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.[141] The waiver system for dark trading has been however capped by volume percentages, which cut down to size the operational space for dark transactions.

However, not all equity instruments are (or should be) admitted to RMs or MTFs. Indeed, some equity instruments are more efficiently distributed and traded on private (OTC) markets, particularly if liquidity is not sought for them or is difficult to obtain at a reasonable cost or the investors' number is relatively low. In similar cases, the admission to a public trading platform would be either impossible (for lack of the required float) or insufficient to create an active trading environment, as is shown by the numerous examples of SMEs whose shares are thinly traded on European RMs and MTFs. Even platforms specifically dedicated to SMEs often do not succeed in getting the amount of trading that is needed for efficient price discovery on these markets. Nonetheless, the MiFID Review will try to enhance the role and status of

---

[140] It has been described as allowing for a substantial fraction of trading to take place in the dark: H Degryse, F de Jong, and V van Kervel, 'The impact of dark and visible fragmentation on market quality' (2011) TILEC Discussion Paper No. 2011-026 < http://ssrn.com/abstract=1815025> accessed 29 June 2013.

[141] Eg IOSCO (n 3) 21-24. On fragmentation risks pre-MiFID see R Davies, A Dufour and B Scott-Quinn 'The MiFID: Competition in a New European Equity Market Regulatory Structure', in G Ferrarini and E Wymeersch (eds), *Investor Protection in Europe: Corporate Law Making, the MiFID and Beyond* (OUP 2006) 163.

SMEs growth markets along the lines examined above, which would imply better investor protection through harmonized regulation supposedly tailored on the specificities and needs of these markets.

We doubt, however, that similar proposals would deeply change and improve the functioning and relevance of SME markets in Europe, given their comparatively high transaction costs and low liquidity. Rather, the perspective should be explored of developing 'low cost' private markets - sometimes also referred to as 'pre-IPO' markets - along the model pursued by several platforms in the US.[142] These Alternative Trading Systems (ATS) are managed by brokers, give access only to institutional investors (investments funds, pension funds, etc.) and professional ones (high net-worth individuals with investment expertise), and are not subject to market transparency requirements. Their transactions generally concern shares, bonds and similar instruments issued by non-listed companies, which remain 'private' under the applicable law (i.e. the provisions relating to public companies do not apply to them). The majority of transactions regard the equity of technology companies, including Facebook, the shares of which (before the 2012 IPO) were privately exchanged on platforms like Second Market and Shares Post.

These private (pre-IPO) markets have emerged in the US as a result of the longer average duration of the venture capital investment cycle. As argued by an informed observer,[143] 'with fewer companies going public, and with those that do staying private longer than before, early start-up employees and venture capital firms (VCs) have experienced significantly longer waiting periods before gaining liquidity in private company stock'. Indeed, the investment in a start-up company 'is essentially illiquid and of uncertain value until the company matures and reaches a

[142] See DC Langevoort and RB Thompson, ' "Publicness" in Contemporary Securities Regulation After the JOBS Act' (2013) 2 *Georgetown L J* 101.
[143] See E Pollman, 'Information Issues on Wall Street 2.0' (2012) 161 *U of Pennsylavania L R* 179.

liquidity event. The liquidity event, typically achieved by the company' acquisition or through an IPO, marks the payoff for the VC and its fund investors. Likewise, employees and former employees in start-up companies have depended on their company reaching a liquidity event in order to cash in on stock earned as equity compensation'.[144] Private markets create liquidity by allowing the sale of securities to take place amongst institutional and professional investors.[145]

In Europe, private markets of this kind could be set-up by investment firms licenced as brokers, while the relevant electronic platforms would possibly qualify as OTFs rather than MTFs, to the extent that trading did not take place on them under non-discretionary rules. Similar platforms would respond to the need of SMEs to find easy access to the financial markets, thus avoiding the hurdles and costs of an IPO.[146] Their focus, however, could extend well beyond the realm of technology start-ups and include the wide range of SMEs that are also the targets of SME growth markets. Indeed, the two types of platforms – the 'pre-IPO' and the MTF type – could also be seen as complementary, to the extent that they facilitate the trading of securities at different stages of a firm's development and maturity as to the capital markets.[147]

2. Proposed OTF Regime

[144] *Ibidem*.
[145] *Ibidem*, 'Shares in private companies previously regarded as illiquid, out-of-reach asset class, are being traded on websites resembling stock markets. Hot demand for private shares of Facebook and other technology and social media companies has fuelled the recent meteoric rise of these online markets'.
[146] For similar comments, A Pritchard, 'Truth in Securities Revisited: Abolishing IPOs and Harnessing Private Markets in the Public Good' (August 7, 2012) *U of Michigan Law & Econ Research Paper No 12-010* <http://ssrn.com/abstract=2103246>.
[147] These suggestions are further elaborated by G Ferrarini and A Ottolia, 'The Transaction Costs of Corporate Disclosure: The Case of SMEs', *European R of Contract L* (forthcoming).

Particular difficulties arise with the OTF regime, as recognized in the draft 2012 Ferber Report,[148] which questions the utility of the new classification and calls instead for a sharper focus on the binary distinction between bilateral and multilateral trading.[149] It may struggle to capture OTC trading in an optimal manner, which enhances transparency in an efficient and fair way. The difficulties are all the greater as equity OTFs are typically designed to assist investment firms in meeting their process-based best execution obligations under MiFID art 21. It would be quixotic were the MiFID Review 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.[150] Currently, it is not uncommon for OTF operators to provide capital to their OTF systems, in order to deepen liquidity, but under MiFIR 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.[151]

The OTF classification also represents an unhappy muddle of organized venue/multilateral trading and bilateral trading concepts. The OTF is treated as an organized venue, and subject to the same rules as MTFs and RMs. But the MiFID II proposals also treat the OTF operator as an investment firm subject to conduct of

---

148 See European Parliament's Committee on Economic and Monetary Affairs, *DRAFT REPORT on the proposal for a directive of the European Parliament and of the Council on markets in financial instruments repealing Directive 2004/39/EC of the European Parliament and of the Council (recast)* (2012) <http://www.europarl.europa.eu/sides/getDoc.do?type=COMPARL&reference=PE-485.882&format=PDF&language=EN&secondRef=01>.

149 *Ibidem* 54-55, regretting the OTF classification, highlighting the risk of loopholes, and suggesting that instead MiFID II define 'bilateral' and 'multilateral' systems more carefully. The Report does not remove the OTF class, but addresses whether MTFs, SIS and OTFs are bilateral or multilateral in nature, and defines these concepts.

150 Final Proposal MiFIR (n 102) Recital 8 states: 'Because an OTF constitutes a genuine trading platform, the platform operator should be neutral. Therefore, the investment firm or market operator operating the OTF cannot execute client orders against its proprietary capital.'

151 This concern was repeatedly raised during the European Parliament's consultation, including, e.g., by the BBA and Deutsche Bank. The UK FSA also raised concern on this issue.

business regulation, in an attempt to capture the distinct discretionary nature of OTF trading. However, one of the key distinguishing features of venue regulation is that client-facing conduct rules do not apply given the multilateral functionality. MiFID II thus introduces a new hybrid animal into the trading environment: one with the head of an organized venue grafted on to the body of an investment firm.[152]

To the extent that existing BCNs are caught into the OTF definition, the impact of the reform would be limited, for similar venues generally trade instruments which are also traded on regulated markets and possibly MTFs. But the consequences would be more difficult to predict with respect to instruments which are only traded OTC. In particular, it is not entirely clear whether the pre-IPO markets examined above would also be subject to the OTF requirements, including those relating to market transparency. Much will depend on how the relevant requirements are formulated in the relevant provisions and on the adaptability of the same. However, we underline the risk of overkill if essentially private markets were forced, under the new OTF regime, to morph into public markets and if the relevant costs would become, as a result, less sustainable for SMEs.

Also with respect to OTC derivatives, which could also be traded on OTFs, an assessment of the reform's impact would not be easy. The same discussions presented for equity instruments can be transposed to derivative instruments. The derivative industry association, ISDA, favourably welcomed the introduction of OTFs.[153] Soon after the financial crisis, in fact, ISDA promoted a standardization campaign, which resulted in higher level of harmonization among derivatives' contractual and operation structures. In addition, derivatives dealers begun to clear their contracts in

[152] The response of the French regulator, the AMF, to the Parliament's consultation, similarly argued that where discretionary rules apply, the trading system is not a venue.
[153] See ISDA, *MiFID/MiFIR: The OTF and SI regime for OTC derivatives*, (2 May 2012) <http://www2.isda.org/mifid/page/2> accessed 3 July 2013.

CCPs. These two factors, together with higher transparency in the markets, contributed to an increase in liquidity in many assets classes of derivatives. Committed to the mandatory trading of clearing eligible and liquid derivatives, ISDA embraced the introduction of OTFs as new trading venue, mainly because of the discretion left to the OTF operators in executing transactions. As already mentioned for equity instruments, ISDA is sceptical about the favourable treatment reserved to multi-dealers platforms over single-dealer ones. By banning the use of proprietary capital by OTF operators, MiFIR proposal excludes single-dealer platforms – currently the most common structure used by banks to trade derivatives – from the OTF definition, shifting them to SIs and therefore making them not eligible for satisfying the trading requirement under MiFIR proposal.[154]

It is however premature to give a final evaluation on how the derivative markets are going to react to the introduction of OTFs. ESMA will be delegated to adopt technical and supplemental regulation on OTF functioning mechanisms, and, more importantly, the proposed MiFIR and MiFID II still have to be discussed and approved through the co-decision procedure. Because of political contingencies – i.e. the European Parliament will discuss the proposed regulations at the very end of its mandate; the Lithuanian Presidency of the Council will be replaced by the Greek one; the German federal political election will take place in late September 2013 – the final vote on MiFIR and MiFID II could result in two possible scenarios. Under the first,

[154] For an industry reaction to the ban on operating OTF with proprietary capital, see David Wigan, 'In the Spotlight: OTFs' (2012) *15 Markit Magazine Spring 2012* <http://www.markit.com/en/about/magazine/issue-15/mm15-in-the-spotlight.page> accessed 3 July 2013. The debate arose from the bank industry. Many banks, in fact, used to operate single-dealer platforms of OTC derivatives and they were considering converting their platforms into OTFs. However, because of the revised proposal and because of the use of proprietary capital to operate these platforms, they would not be allowed to provide such services anymore. ISDA itself heavily criticized the potential impacts of 'the proposed ban on an OTF operator executing client orders against his own proprietary capital' on single-dealer platforms. Banks operating in derivatives, however, waiting for the final rules to be adopted, have continued to operate their single-dealer platforms connecting them to existing OTFs through web portals.

the current Parliament, willing to approve all financial reforms by the end of its mandate and therefore more vulnerable to lobbies' pressures, approves the final texts with more concessions to the financial industry. Under the second scenario, the approval of MiFID II and MiFIR is left to the Parliament emerging from the next European political elections.

3. Non-equity Trading and Transparency: Public interest v. private incentives

Also in this area it is too early and difficult to predict how practice will react to the new rules, which are however still incomplete.[155] Markets, however, have begun reshaping along the FSB principles: reporting, central clearing, standardization, transparency and exchange on trading venues are being *de facto*, albeit partially, implemented in anticipation of the new rules.

Unfortunately, meaningful data is generally unavailable to enable progress to be tracked. While it is clear that, worldwide, progress towards organized trading of OTC derivatives is lagging behind what seen in respect of other G20 commitments,[156] market participants are pro-actively transforming the derivatives markets. Firstly, new trading venues for derivatives have appeared, such as the interest rate swaps trading platform (MTS Swaps) recently launched the London Stock Exchange Group.[157] More generally, existing trading venues are being re-modelled to offer standardized swap derivatives trading, while CCPs extend clearing activities to derivatives.

[155] ESMA has still to adopt secondary level regulations and national authorities still have to proceed with the official authorization of TRs and CCPs. See FSB, *supra* nt 41. Moreover, insider information suggest for a delayed implementation of reporting obligations to 2014, see <http://thetradenews.com/news/Regions/Europe/EMIR_derivatives_reporting_likely_delayed_to_2014.aspx> accessed 3 July 2013.

[156] See FSB (n 42) 28.

[157] See <http://www.reuters.com/article/2013/06/14/markets-lse-idUSL5N0EQ1A120130614> accessed 3 July 2013. 'Interest rate swaps comprise the biggest chunk of the world's $633 trillion off-exchange derivatives market which has traditionally been traded privately among banks. Trades on MTS Swaps will be cleared on LCH.Clearnet, one of the world's biggest clearing houses for interest rate swaps and in which the LSE has recently acquired a controlling stake' (14 June 2013).

Secondly, derivative exchanges are positioning themselves to reap the benefits of the new regulatory environment and also to defend their franchises, as shown by Intercontinental Exchange (ICE)'s acquisition of NYSE Euronext, which was recently approved by the European Commission and will result in the creation of one the largest derivatives exchange group globally, after CME and the Hong Kong Exchanges and Clearing.[158] Thirdly, a new phenomenon known as 'futurization of swaps' is emerging, mainly in the US. Given that the OTC markets will be extensively regulated, derivatives exchanges are now offering future contracts which replicate the financial structure and functions of standardized swaps.[159] Futures exchanges are regulated, multilateral, lit, and non-discretionary, so that they offer the type of trading environment that regulators prefer also for OTC derivatives. Private parties are no doubt considering the relevant transaction costs and may find that, once the new rules for OTC derivatives are fully implemented, futures will often represent a cost-effective solution to their hedging or investment needs.

Commentators described this phenomenon either as a failure in the regulatory process,[160] or evidence of markets adaptation to structural changes.[161] The futurization

---

[158] See <http://www.reuters.com/article/2013/06/24/us-nyse-ice-eu-idUSBRE95N0Q120130624> accessed 4 July 2013.

[159] Standardized swaps are functionally similar to futures. A swap provides for regular exchanges of cash flows over a specific amount of time. A future is the obligation to make a delivery or a payment of a specified amount at a precise time in the future.

[160] On this position see R Litan, 'Futurization of Swaps – A Clever Innovation Raises Novel Policy Issues for Regulators' (14 January 2013) *Bloomberg Government Analysis* <http://www.darrellduffie.com/uploads/policy/BGOV_FuturizationOfSwaps.pdf>. Litan reconsiders the argument that financial innovation goes faster than regulators, which are always one step behind the financial industry, *id* 3. The financial industry is able to extract benefits from regulatory loopholes and delay, by quickly adapting to the imperfect and incomplete system. The futurization of swaps is the clear example of this manifestation of regulatory arbitrage. Regulators, too focussed on the cross-country issues and on the risk of transnational regulatory arbitrage, did not realize, or even accept, the risk of migration of swap contracts to other markets which satisfied the systemic stability principles at the base of the reforms – see mandatory clearing, mandatory treading and mandatory reporting. Litan criticizes the inability of regulators to foresee this market migrations, and offers three possible solutions: 1) accepting market's decisions and 'take consolation in the fact that at least standardized swaps-like instruments will be exchange-traded and cleared' on future platforms; 2) aligning the futures and swaps regulatory regimes; 3) increasing competition in the clearing and exchange industry; *id* 5.

of swaps is in fact a manifestation of regulatory arbitrage. Swaps dealers, in a market scenario where OTC derivatives have become highly standardized and where high liquidity and trading volume characterize many asset classes, may prefer to switch to futures and get the benefits of organized trading from now, possibly also exploiting regulatory loopholes in the traditional regulation of future trading vis-à-vis the new rules which are being implements for OTC derivatives trading.[162]

Going back to the MiFIR proposals, those concerning non-equity instruments focus on bonds and OTC derivatives and transparency of the relevant trades, and reflect a longstanding policy discussion recently revived by the financial crisis. The crisis added new arguments in favour of transparency that were promptly exploited by politicians and regulators to propose legal reform in this area. Also retail investors and to some extent institutional investors actively advocated more transparency for non-equity markets, shifting the balance between interest groups from those fiercely opposing transparency (mainly intermediaries active in the relevant markets) to those favouring the same (initially only exchanges and with little interest; now also investors, both retail and professional).

As a result, transparency of non-equity markets has been proposed by the European Commission and accepted by the majority of market participants. However, the need has also been recognized in the MiFID Review of calibrating non-equity

---

[161] In response of Litan's comment, see D Duffie, 'Futuritization of Swaps – Stanford's Duffie Offers Another Viewpoint of this Emerging Trend' (28 January 2013) *Bloomberg Government Analysis: Counterpoint* <http://www.darrellduffie.com/uploads/policy/DuffieBGOV_FuturizationOfSwaps.pdf>. Duffie analyses the phenomenon from a market perspective, describing the evolution from OTC markets to exchange markets. OTC dealers play an important role by absorbing and providing a market for illiquid and thinly traded contracts. Exchanges, on the other hand, have the relevant economic function as providers of liquidity in markets with standardized and traded instruments. After the financial crisis and the adoption of the Dodd-Frank Act in the US, OTC derivatives reached higher standardization and were mandated to be traded on exchanges, to be centrally cleared and to be subject to pre- and post-trade transparency: 'dealers did not have much incentive to encourage the futurization of swaps', because of the high profits of the OTC activities – run by derivative dealers in an oligopolistic environment, *id* 2. However, in conclusion, Duffie argues that 'the migration of derivatives from an OTC market to an exchange-trading environment is a healthy trend for standardized and actively traded products'; *id* 4.

[162] The Dodd-Frank regulation, in fact, imposes high implementations costs on swap dealers.

transparency to the specificities and needs of the different types of instruments, investors and markets. This will shift a non-negligible part of the reform to delegated acts, which will define the scope of both pre-trade and post-trade transparency.[163] Moreover, national competent authorities will be empowered to grant waivers from the obligation to publish pre-trade information under the supervision of ESMA.[164] They will also be enabled to authorise regulated markets and investment firms and market operators operating an MTF or OTF to provide for deferred publication of the details of transactions based on their type or size, but always within the framework of MiFIR and its delegated acts.[165]

It is difficult to predict which room for private markets on non-equity instruments will be left under MiFID II and MiFIR. Indeed, most of the trading of similar instruments presently occurs OTC, but it is likely that MiFID Review will determine substantial changes in this regard. Once post-trade transparency is imposed also on OTC markets, public markets will no doubt attract greater volumes of trades. In fact, once both public and private markets are lit, one of the reasons for trading OTC will disappear. Moreover, the new capital requirements for banks under Basel 3 will reduce the possibility for dealers to provide liquidity for the trading of bonds and similar instruments in amounts greater than on public markets, despite the absence of pre-trade transparency requirements in OTC markets (an aspect which may important from the perspective of dealers).

Also for derivatives markets it is difficult to anticipate to what extent they will remain OTC. No doubt, there will be an obligation to trade on public markets those derivative contracts which are sufficiently liquid and standardized under the requirements fixed by ESMA. However, at least in the near future, only a few types of

---

[163] Final MiFIR Proposal, art 8(4) and art 10(2) (n 102).
[164] Final MiFIR Proposal, art 8(1) – (3) (n 102).
[165] Final MiFIR Proposal, art 10(1) (n 102).

derivative transactions will comply with those requirements and automatically migrate from OTC markets to organized and public ones. For the rest, private derivatives markets will become more transparent and safer (to the extent that the clearing obligations will be implemented in practice) – in other words, they will be more 'regulated' and therefore 'semi-private' – which might also create incentives for investors and traders to spontaneously move their transactions to organized trading venues. As already stated in our EMIR's evaluation, room will be in any case left for customized OTC derivatives, subject only to mandatory reporting to trade repositories.

Derivatives markets reform may find some support also in the recent initiatives by the European Commission in the area of antitrust enforcement.[166] Without taking position on these initiatives, which are too recent and largely confidential at this stage, we forecast that antitrust enforcement in this whole area will side-up with EMIR and MiFIR in a joint effort by regulators to reduce the transaction costs of securities and derivatives trading through enhanced competition and transparency in the relevant markets.

F. CONCLUSIONS

In this paper, we have examined the extent to which current reforms are expanding the regulation of 'public' securities markets – including transparency and market

[166] The antitrust division of the Commission recently opened investigations against derivatives dealers and ISDA, alleging – with a specific focus on CDSs markets - that they were colluding to restrict competitors' access to derivatives trading platforms. See Alex Barker, 'Banks charged with blocking CDS market' *Financial Times* (Brussles, 01 July 2013); James Fontanella-Khan, 'Brussels includes ISDA in antitrust probe' *Financial Times* (Brussel, 26 March 2013); Joshua Chaffin and Jeremy Grant, 'Brussels opens CDS antitrust probes' *Financial Times* (Brussel, 29 April 2011).

organization rules – while correspondingly reducing the scope of 'private' markets (which broadly coincide with the OTC markets). We have also analysed whether regulation should pull a wider range of trading venues into the regulatory net, with particular reference to the new OTF functionality.

In general, the crisis has had a profound impact on legislation relative to the structure and functioning of securities and derivatives markets. The guiding principles for reforms were set at international level, while the implementation of those principles occurs at regional and national levels. Also the EMIR and the MiFID Review reflect international proposals firstly advanced by the G20 and then specified by the FSB and IOSCO. No doubt, interest groups have influenced these regulatory initiatives, exchanges and intermediaries in particular (who were the main actors in MiFID's formation), but also issuers and investors (who have become more active in the policy arena only after the crisis). Moreover, politicians have taken a more visible stance in promoting investor protection and market transparency, as shown, for instance, by the European Parliament's 2010 Resolution expressing concern on the scale of OTC trading. In this paper we have mainly moved from a public interest analysis perspective, conscious however of the influence of interest groups in this area of legislation.

Our analysis has shown how EMIR fixes the financial infrastructures and sets the new grounds for the OTC derivatives markets. Higher transparency for derivative instruments, mandatory clearing for eligible contracts, and mandatory reporting to trade repository for any derivative transactions, all move in the direction of fostering transparency in the markets and mitigating systemic risk. Markets have actively and quickly responded to the new regulatory initiates with a remarkable increase in the standardization of derivatives, which has also led to a massive migration of standardized and liquid derivatives to CCPs and exchanges or other trading venues.

At the core of the MiFID II proposals is the concern to extend the regulatory perimeter to encompass a wider range of venues and submit the same to similar rules. A concern to shrink the OTC markets might also be regarded as implicit in the proposals. The new OTF regime is designed to capture all non-RM/MTF trading other than ad hoc bilateral trading between counterparties which does not take place on an organized venue. Moreover, new art 20(c) of MiFIR includes an unprecedented obligation to trade shares admitted to trading on a regulated market or traded on a trading venue, on a regulated market, MTF, OTF or systematic internaliser, as appropriate. Only two exceptions are presently foreseen with respect of trades which are either 'non-systematic, ad-hoc, irregular and infrequent' or 'are carried out between eligible and/or professional counterparties and do not contribute to the price discovery process'. The role of private markets would no doubt be restricted were this provision finally adopted, even if room would still be left for private markets either in illiquid shares or amongst professional investors.

The MiFIR Proposal also includes rules on transparency for non-equity instruments, based on the premise that the financial crisis exposed specific weaknesses in the way information on trading opportunities and prices in financial instruments other than shares is available to market participants. The proposed rules will introduce a transparency regime in the markets for bonds, structured finance products and derivatives, so as to help the valuation of products and the efficiency of price discovery.

Our criticism of the MiFID Review mainly concerns some potential weaknesses, which could affect the scope for OTC trading in the equity markets.

Indeed, there are benefits of private markets for investors, which include liquidity provision, price impact protection, and lower execution costs. Moreover, not all OTC equity trades concern instruments admitted to RMs or MTFs. In fact, some equity instruments should only be traded on private markets, which are generally less liquid than public ones. Nonetheless, either liquidity is not sought for these instruments by issuers and investors, or is difficult to obtain at a reasonable cost. In similar cases, the admission to a public trading platform would likely be insufficient to create an active trading environment.

As argued in this paper, it is difficult to predict whether the room for private (or semi-private) markets on non-equity instruments will remain broad in the new MiFID scenario. Indeed, most of the trading of similar instruments presently occurs OTC, but MiFID II will likely determine some changes in this regard, given that – once OTC markets have become post-trade transparent – public markets might attract greater volumes of trades.

A conclusive answer to this question will only be possible once the regulatory framework has been finalized and will also depend on the dynamics of the marketplace and the actions that dealers and traders will take in the near future. However, some potential concerns already emerge, such as the limitation of post-trade transparency obligations to traded derivatives (art 20 MiFIR), which appears to be too narrow. Indeed, derivatives subject to mandatory clearing in general – rather than only derivatives traded on trading venues - would appear to be fit for this type of transparency, given their standardization and liquidity. The analogy with cash instruments, which are also subject to post-trade transparency in OTC trading if traded also on exchange, does not hold, given the clear differences between cash and derivative instruments as to secondary trading.

OTC private markets will likely continue to play an important role as provider of customized hedging derivatives, subject only to a generic reporting obligation (trade repositories will publish only aggregated data). Conversely, the role that OTFs could play for derivatives is still difficult to detect, as it is not clear whether dealers and traders have an interest in moving standardized transactions to this new type of organized facility, rather than directly to either RMs or MTFs.