

EFAMA calls for reference price waiver to be retained

EFAMA is the representative association for the European investment management industry. EFAMA represents through its 26 member associations and 59 corporate members approximately EUR 14 trillion in assets under management of which EUR 7.9 trillion was managed by approximately 54,000 funds at end March 2012. Just above 36,000 of these funds were UCITS (Undertakings for Collective Investments in Transferable Securities) funds. For more information about EFAMA, please visit www.efama.org.

We are concerned by proposals to remove the waivers from pre-trade transparency including those provided under MiFID. These waivers provide much needed protection for institutional long term investors from the activities of short term profit takers while at the same time not impacting on the overall transparency and efficiency of the markets – the Commission’s prerequisite in terms of this element of policy.

Retaining a reference price waiver

Introduction

The reference price waiver has been recognized since the Level 2 MiFID I regulation. It has been the subject of the majority of decisions made first by CESR and now ESMA concerning uses of pre-trade waivers by regulated markets (“RM”) and Multilateral Trading Facilities (“MTF”). These are recorded in ESMA's April 2012 publication “Waivers from Pre-trade Transparency”.

The publication and the number of decisions, as well as the recorded dissenters, demonstrate that:

1. the waiver is critical to the functionality of several business models; and
2. there is disagreement amongst some regulators as to what should or should not be allowed.

MiFID currently makes use of four waivers:

- Large in Scale Waiver (LSW).

This is used to exempt large orders from pre-trade transparency thereby avoiding market impact.

- Reference Price Waiver (RPW)

This allows trading venues to determine prices by reference to a widely published price instead of actual prices and has numerous benefits for market efficiency and ultimately end-investors as we explain below.

- Negotiated Transaction Waiver (NTW)

This allows trades to be concluded off exchange (between two market participants or between a market participant and the operator of the trading venue) at a price that is in line with current market conditions.

- Order Management System Waiver (OMSW)

This allows venues to split large (“parent”) orders into small (“child”) orders. The small pieces are pre-trade transparent, but when the remaining size of the large order falls below large in scale, that part is also kept dark.

To fulfil best execution of large client orders, asset managers would typically seek to execute the trade across the full range of execution venues. The buy-side trader will factor in the cost of execution and more recently, the risk of interacting with the Central Limit Order flow provided by High Frequency Traders (HFT).

The MiFID waivers are often used in combination with each other since they interact to safeguard and facilitate institutional investors' ability to efficiently implement substantial investment decisions - a key element of the MiFID I regime. Mid-point crossing is another satisfactory and commonly used technique to match buyers and sellers where there isn't any value from an end-investor perspective in routing the order to the CLO.

How does the use of MIFID waivers translate into benefits for end-investors and the "real economy"?

MiFID waivers are the mechanisms through which execution choice is made possible:

- Increased liquidity

The possibility to use waivers brings participants into the market that would not have otherwise been there. Likewise, the removal of the waivers will not, we believe, translate to a direct shift of liquidity from 'dark' to the 'lit' markets. Instead it will segment client orders into those which can benefit from crossing and those that cannot.

- Lower costs

At present, a broker with two opposing institutional orders can automatically match the orders, or parts of them, at the same price. Without this possibility, the broker would be forced to incur spread costs on behalf of both of its clients by accessing a 'lit' order book. The buying client then pays a higher price than the selling client for no good reason.

- Less risk of the market moving against the client's interest

Without the protection the waivers provide, the broker would force to publish orders and thus flag their clients' intent to the market. With this information the market could move against the client, which is an unnecessary risk and avoidable cost for the end-investor.

Execution choice and quality is an increasingly important element. The benefits to end-investors of executing client orders away from the CLO are possible due to the existence of the MiFID waivers.

Which venues would be allowed to use waivers?

In any discussion as to the need to retain the waiver, it is important to be clear as to the trading venues to which the waiver would apply. The reference price waiver which operates for MTFs and RMs should be extended to Organized Trading Facilities (OTF) and must not be confused with the subject of broker-crossing networks (which are part of the market infrastructure organization rather than transparency efficient enhancement). It must not be forgotten that in any circumstance in which the pre-trade reference price waiver operates, any executed transaction will always be required to be published without delay and could not qualify for any post-trade delay.

Helping long-term investors and financing the SME market

The reference price waiver allows asset managers to place orders to buy or sell large blocks of equities on behalf of their clients, commonly a range of funds, life pools and pension schemes. These long-term investing clients are vulnerable to the risk that other market participants will identify their need to trade in large size and move the price against them. The suppression of the reference price waiver would limit the capacity of long term investors to invest in the SME market because of important execution cost and impact finally the potential growth of the global economy.

EFAMA's proposal

Whilst there is a large in scale waiver from pre-trade transparency we fear it will be set at a level too high to protect enough trades.

The reference price waiver needs to be retained in order for the asset managers to be comfortable placing an order in any sort of real size either with a broker or directly on a platform. If we do not retain only the "large-in-scale" waivers (or indeed the "negotiated trade" waiver) asset managers would not have the confidence to place block orders in the market without their intentions being made public; our members would have to micro-manage each order by showing only very small size transaction requests to the market to avoid the "signaling risk". We have already seen that the size of available liquidity at the touch price in the lit market has diminished to extremely small amounts since the advent of high-frequency-trading, and we would not want to have to slice orders down to this extent.

Consequently, EFAMA members and their clients rely on the reference price waiver to allow them to advertise block transactions without divulging the information to the wider market.

So we propose that:

1. The waiver is retained and referenced in the legislative act (MiFIR, art. 4 and 8); and
2. Implementing standards could be used to set out the detail of where the waiver could be used, having regard to ESMA and CESR discussions and dissenting opinions (see below); and
3. ESMA should be asked to draft implementing standards that provide a regime in which the largest of trades were covered by the large in scale waiver, other trades will participate to the price information; and

As regards the different viewpoints between members of CESR and now ESMA, it is entirely possible for these to be dealt with in implementing standards.

Whilst the ESMA process is transparent as to the result, putting more detail in an implementing standard might reduce demands on ESMA and provide greater ex ante certainty to those designing new functionality at trading venues. So the uncontroversial issues could be recorded in implementing standards but also the functionalities which do not satisfy the current MiFID criteria could be set out.

In particular, it should be clarified whether or not and under which condition (references to examples are as numbered in the ESMA document):

- two sides of the quotes could be taken from different and multiple systems;
- participants could place price caps or floors – price limits - on the order submitted for crossing.

Conclusion

If EFAMA's proposal were followed, we would hope that concerns that there any loss of information for the price discovery process would be insignificant compared to the benefit to the long-term investors. Additionally, as both markets and patterns of order execution are dynamic and as fulfill best execution requirements practices evolve over time, it would be appropriate therefore to review implementing standards over time.

We would welcome the opportunity to discuss these issues further.

11 December 2012

[12-4060]