European Federation for Retirement Provision

4 May 2012

EFRP Position Paper

On

The Proposal for a Directive on markets in financial instruments repealing Directive 2004/39/EC (MiFID II) – 2011/0298

And

The Regulation on markets in financial instruments and amending Regulation [EMIR] on OTC derivatives, central counterparties and trade repositories (MiFIR) – 2011/0296

About the EFRP

The **European Federation for Retirement Provision (EFRP)** represents national associations of pension funds and similar institutions for supplementary/occupational pension provision. Its membership covers institutions for work-related (2nd pillar) pension provision. Some of them operate purely individual pension schemes (3rd pillar).

The EFRP has **22 members associations** in most EU-15 Member States and other European countries with significant – in size and relevance – workplace pension systems[1].

In October 2006 the EFRP established the **Central & Eastern European Countries Forum (CEEC Forum)** to discuss issues common to pension systems in that region.

EFRP member organisations cover the workplace pensions of **83 million European citizens**. Through its Member Associations the EFRP represents approximately € **3.5 trillion of assets (2009) managed** for future occupational pension payments.

EFRP Members are large institutional investors representing the **buy-side** on the financial markets. They are specialised institutions solely dedicated to the accumulation and decumulation of assets to provide a supplement to the State pension to avoid old-age poverty.

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[1] EU Member States: Austria, Belgium, Finland, France, Germany, Hungary, Ireland, Italy, Luxembourg, Netherlands, Portugal, Romania, Spain, Sweden, UK. Non-EU Member States: Croatia, Guernsey, Iceland, Norway, Switzerland.

Introductory statement

The EFRP welcomes and supports the general purpose of the MiFID review. We promote good pensions for all European citizens and believe that one important way to achieve this is by keeping the operating costs for pension funds down, while not creating any disadvantageous rules for them compared to those applicable to other financial actors. This allows pension plan members to obtain the highest pension benefits. As long-term investors, pension funds are strongly in favour of transparency, information disclosure and stronger safeguards for investment activities. The great majority of pension funds are not-for-profit and they play a stabilising role in the financial markets through their long-term investments.

We broadly welcome the Commission proposals and agree with most of the amendments proposed by the European Parliament *Rapporteur*, Mr. Markus FERBER.

The EFRP is concerned, however, that some of the elements in the proposals do not take the specific needs and characteristics of pension funds investment policies into account. In their current form, some elements of the MiFID II and MiFIR Proposals could have negative consequences on the financial activities of pension funds. We would ask, therefore, that the European institutions reconsider those specific proposals (see further below).

We are strongly supportive of increasing transparency in the markets, but would therefore warn against the commercial interests which may lie behind the application of this valuable principle in the current proposals. For example, high-frequency traders and other speculative operators could take undue advantage of investments by long-term investors such as pension funds if the current proposals are adopted.

The EFRP therefore calls for a tailored legislative approach, which treats pension funds, as long-term investors, differently from other financial actors. We support a smart application of the transparency principles, which will allow pension funds and asset management companies acting on their behalf, to interact with other market participants on a fair basis. Pension funds should be allowed to comply with transparency principles and, at same time, to continue pursuing the best interest of their beneficiaries: millions of European citizens who expect their workplace pension benefits.

General remarks

Pension funds, as long-term institutional investors, handle block orders. We would like to see the MiFID II and MiFIR Proposals take this into account. We believe that a degree of flexibility in the execution of large and illiquid order is necessary to ensure appropriate risk-management and minimisation of costs, from which pension fund members will benefit.

In this respect, the current proposals on organised trading facilities (OTF), systemic internalisers (SI), pre- and post-trade transparency, algorithmic/high frequency trading and mandatory trading of derivatives on trading platforms places could have a negative effect on pension funds, since they apply in the same way to all financial market participants. We understand that these proposals express the laudable aim of increasing transparency in financial trading, but they may:

1. Favour short-term oriented market participants over long-term institutional investors: high-frequency traders and other speculative operators could take undue advantage;

2. Offer trading venues the opportunity to take undue commercial advantage from pension funds' investment activities. This commercial advantage would not be counterbalanced by any benefit for the trading activity of pension funds, and hence for their members. Therefore, it would only represent an unjustified cost for pension funds, affecting the returns on investments and, ultimately, the contributions paid to workplace pension beneficiaries.

Please find below a number of remarks on key issues for us and on specific amendments proposed by the *Rapporteur*.

Key issues

1. **Pre-trade transparency:**

   i. *Waivers*: the MiFID II/MiFIR Proposals should take into better account the market practices of many institutional investors, which use to slice their "parent" orders into smaller "child" orders. **Any waivers for large in scale investors should apply to these smaller orders as well**; otherwise, high-frequency traders and other short-term speculators would use the information on the smaller child orders to detect the larger parent order and front-run the parent order. Without such an extension of waivers, the current proposals would give the mentioned market operators an unfair competitive advantage.

   ii. *Instruments other than equities*: pre-trade transparency requirements should take into account that transactions are traded on a quote-driven market (and not on an order-driven market as for equity transactions), with specific trading systems (i.e. not a central order book). If bids and offers arae made transparent, such information would be used by market participants (e.g. high-frequency traders and other short-term speculators) to front-run the large (or illiquid) orders of pension funds and other long term institutional investors. **We ask for pension funds and asset management companies acting on their behalf not to be required to disclose their pre-trade data to the public**, in order to avoid such a situation. In any case, **all the transactions from all venues should be reported to supervisors in real-time**: operators of OTFs and SIs should provide all information on their trading volumes to supervisors.

2. **Post-trade data publication:**

   i. **Parent-children orders data publication disclosure shall be deferred and not be made transparent**, as this would have the effect of double reporting. The reasons for this deferral are the same as explained above: some short-term or speculative operators would take an undue advantage from this information. If small child orders would be published, the presence of the child orders would be inferred by other market participants, resulting in front-running of the parent order. The order flow of institutional investors is less likely to be detected by speculative actors, if the child transaction data are amalgamated before disclosure to the public.

ii. **OTC derivatives position data should be disclosed to the public on an aggregated**, anonymous basis and with an appropriate delay period: immediate disclosure of the data in respect of pension funds' positions to other market participants will have severe adverse effects on pension funds' ability to trade and hedge liabilities. Market participants may use pension funds' position data to plan their trades: this could be extremely harmful for hedging purposes, which are pursued by pension funds when trading derivatives. Once more, there might be a risk of front-running by market participants who would be aware of the large transaction to be carried out. Moreover, the confidentiality of pension funds' trade confirmation should be guaranteed. This has also been recognised in the IOSCO and CPSS report on OTC derivatives data reporting and aggregation requirements (pages 21-22). Furthermore, the different post trade transaction reporting mechanisms, as incorporated in EMIR and MiFIR, shall be aligned. It's worth recalling that in the United States, the CFTC decided to withdraw its initial proposals on the definition of block trades and the term for deferred publication of such trades. The EFRP suggests that the EU institutions adopt a careful approach when defining which trades are to be considered large in scale and we would be in favour of detailed definitions in Level 1 legislation, to ensure appropriate attention, through democratic channels, for buy-side investors' needs.

3. **Organised Trading Facilities:**

Pension funds recur to non lit trading venues to trade large in scale and illiquid assets, when liquidity is not available in lit markets, when there is high interference by high-frequency trading activities or when market disturbance can be expected. Under the current Proposals:

i. OTF investment firms can only match client orders; hence, they're not allowed to trade with their own capitals;
ii. SI investment firms can trade versus their own capital, but cannot match client orders and have a market making obligation.

These provisions will both lead to a reduction of liquidity available on the market. Therefore, pension funds and companies acting on their behalf shall be enabled to choose to trade outside lit trading venues to execute large (and illiquid) blocks, which may be difficult to achieve by trading through lit trading venues, due to a lack of depth in the order book, to avoid information leakage and to minimise market impact costs. **Pension funds should have the possibility to choose to place their orders in an OTF, in a Market Trading Facility (MTF), in an SI or to recur to traditional exchanges to obtain best execution of their order.**

4. **Commodity markets**:

The EFRP is in favour of disclosing information on positions to supervisors, but opposes the idea of disclosing holdings more generally.

On specific Amendments

Amendments 1, 16 and 28-37 to MiFIR: Contrary to what the Rapporteur has proposed, the EFRP believes that Broker Crossing Networks, regulated as OTF or SI, should be allowed in the equities markets. Broker Crossing Networks are essential for institutional investors to achieve good returns on investments, because of the opportunity they offer to reduce the costs of trading. If the OTF regulation is extended to Broker Crossing Networks, then they should apply to the equities market as well. It would ensure good functioning of the financial markets, without affecting security. Investment firms that operate an OTF (whether for equity or non-equity) should be allowed to use their own capital and provide the liquidity necessary for trades to take place. This measure would lower spreads and, therefore, costs. Moreover, a prohibition on OTF investment firms to use their own capital would not be consistent with the Capital Requirements Directive. Article 5(2) of the CRD recognises that investment firms sometimes trade on their own account, but only in order to facilitate the matching of client orders on a temporary basis. This practice is less risky than trading on a 'principal' basis. As long as investment firms comply with the requirements for trading on a 'matched principal' basis, they should be allowed to use own capital when operating an OTF. In this case, they should be required to disclose their participation in their crossing network to give the client the possibility to decide whether or not to interact with the brokers' market-making within a transparent framework.

We do not support **Amendment 44 of MiFIR,** because we see a clear risk of unfair competition in the new rules on disclosure set in the proposals: if investments firms operating as an SI were to publish or disclose firm quotes to their clients on request, short-term and/or speculating traders may detect the flow of institutional investors and take undue speculative advantage from it or interfere with it. Pension funds would have clear difficulties in pursuing the best price if this happens, particularly where illiquid financial instruments are concerned. The EFRP is, however, in favour of full information disclosure to supervisors. For these reasons broker crossing networks, in the form of an organized trading facility or a systemic internaliser, should be facilitated and not be restricted for any asset class. No market making obligation should be imposed to SIs, as this would harm the trading opportunities of pension funds and long term institutional investors.

Amendments 14, 43 and 44 MiFID II: The EFRP welcomes the Amendments 14, 43 and 44 MIFID II, as suggested by the *Rapporteur*, aiming to introduce a definition of HFT. Pension funds experience hinder from some HFTs in their daily trading activities. Yet, we see a risk of regulatory arbitrage in the definition of HFT proposed by the *Rapporteur*: the percentages and the four cumulative elements in such a definition could be used to avoid being covered by it. We would suggest allowing ESMA or the Commission to better define the technical standards to be included in this definition, including the percentages suggested by the *Rapporteur*.

Amendments 12, 113 and 119 MiFID II: we support these proposed amendments, but would suggest improving the text of Amendment 12 to clarify that the fee structure of trading venues should not encourage investors to engage in very frequent trading.

Amendments 42, 57 and 58 MiFID II: We support Amendment 42 and 57 MiFID II, because pension funds and asset management companies acting on their behalf already have measures and check and balances in place to avoid that algorithmic trading activities interfere with an orderly functioning of the markets. The EFRP also shares the purpose pursued by Amendment 58 of MiFID II.

Article 24 of MiFIR: Pension funds use OTC derivatives to hedge against certain risks and, by virtue of article 18 of the IORP Directive, are prohibited from using derivatives for speculative purposes. It is important for pension funds to use tailor-made derivatives contracts in order to optimise risk mitigation. This possibility would be reduced under the current proposal. We call on the European institutions to ensure that pension funds can continue to resort to this risk management tool. Article 24 should therefore also apply to pension scheme arrangements that will be exempted from clearing during the transition period under EMIR rules. If not, pension funds would incur higher costs, which would harm the benefits paid to pension plan members. We therefore suggest that an amendment in this sense be made.

Amendments 10, 13 and 116 to MiFID II: it is important for pension funds to continue to have direct access to electronic trading firms, since the alternative would be to set up this infrastructure themselves. This would cost considerable resources which will be taken away from pensioners' benefits. That is why the EFRP is opposed to these amendments.