

June 18, 2015

Via Electronic Mail

MiFID 2 Consultation
Securities and Markets, Financial Services Group
HM Treasury
1 Horse Guards Road
London SW1A 2HQ

Re: Response to HM Treasury Consultation on Transposition of the Markets in Financial Instruments Directive II

Dear Sir or Madam,

Citadel LLC¹ (“Citadel”) appreciates the opportunity to respond to HM Treasury (“HMT”)’s consultation on “Transposition of the Markets in Financial Instruments Directive II” (the “Consultation”).² We wish to bring a specific issue relating to the new Organised Trading Facility (“OTF”) category of trading venue to the attention of HMT given that the implementing legislation proposed by the Consultation will address certain aspects of OTFs’ operation and their authorisation regime. The principles discussed in this response also, however, apply more broadly to multilateral trading facilities (“MTFs”) operating under the MiFID II regime.

We are concerned that if the “non-discriminatory access” principle set out in Article 18(3) of the MiFID II Directive³ – that “*investment firms and market operators operating an MTF or an OTF establish, publish and maintain and implement transparent and non-discriminatory rules, based on objective criteria, governing access to its facility*” – is not implemented effectively, there will be adverse impacts on competition, efficiency, liquidity, and investor choice in the market.

With this in mind, please see below our response to Question 22 of the Consultation, which

¹ Established in 1990, Citadel is a leading global financial institution that provides asset management and capital markets services. With over 1,100 employees globally, Citadel serves a diversified client base through its offices in the world’s major financial centers including Chicago, New York, London, Hong Kong, San Francisco and Boston.

² Available at:
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/418281/PU_1750_MiFID_II_26.03.15.pdf

³ Directive 2014/65/EU.

we would like to be treated as confidential.

22. Do you have any additional comments on how the government has transposed the MiFID II OTF regime?

Article 18(3) of the MiFID II Directive states that “Member States shall require that investment firms and market operators operating an MTF or an OTF establish, publish and maintain and implement transparent and non-discriminatory rules, based on objective criteria, governing access to its facility”. Citadel believes that it is vital that national competent authorities ensure that the rules, policies and procedures of MTFs and OTFs firmly adhere to this “non-discriminatory access” principle. We therefore encourage HMT to take further measures in the UK implementing legislation (or in connection with it) that both; (i) prohibit legacy trading venue rules or practices that would violate the “non-discriminatory” access principle; and (ii) pre-empt the introduction of any such new trading venue rules or practices.

Any trading venue rules, policies, procedures, or access criteria that explicitly or implicitly either erect a barrier to entry for new competitors in a market or exclude an entire class or category of otherwise eligible market participants are by definition discriminatory and not objective. Notably, the recent Final Report of the UK Fair and Effective Markets Review (“FEMR”)⁴ stated that “if the move to OTFs is to be successful in broadening access within FICC markets, it will be necessary for supervisors to monitor OTFs actively to ensure that venues do not introduce or maintain access criteria that serve to exclude market participants unnecessarily.”⁵ This monitoring will be strengthened and facilitated by implementing legislation that further defines the “non-discriminatory access” principle.

The FEMR Final Report further states that “competition authorities including the FCA need to be alert to the potential for incumbents seeking to prevent the development of challenger technologies through anti-competitive structures or behaviour”⁶ and that “competitive impediments, including limitations on access to essential infrastructure”⁷ are of concern. Indeed, erecting discriminatory barriers to access to certain trading venues is one of the chief methods that incumbents use to limit competition. The implementing legislation proposed by the Consultation thus provides an opportunity to check and remedy anti-competitive structures or behaviour in the marketplace.

⁴ Available at: <http://www.bankofengland.co.uk/markets/Documents/femrjun15.pdf>

⁵ See Box 3, page 29 of the FEMR Final Report.

⁶ See Page 16, paragraph 44 of the FEMR Final Report.

⁷ See Page 16, paragraph 44 of the FEMR Final Report.

The Need for Non-Discriminatory Access in the OTC Derivatives Markets

The OTC derivatives markets provide an important illustration of the need for and importance of effective implementation of the “non-discriminatory access” principle. The OTC derivatives markets have historically operated as a “two-tier” market, where:

- a select group of dealers transact with each other on exclusive “dealer-only” trading platforms, commonly referred to as the “inter-dealer” or “D2D” market;
- such inter-dealer trading platforms deny access to both new competitors and all non-dealer market participants, including customers (e.g., corporations, investment funds, insurance companies); and
- customers can only trade with that select group of dealers, either bilaterally or on a limited number of “dealer-to-customer” or “D2C” trading platforms.

The “two-tier” market is opaque, inefficient and harms customers by fragmenting liquidity, creating barriers to entry, limiting competition, hindering access to best execution, and concentrating risk among a handful of incumbent dealers. The “non-discriminatory access” provisions of the MiFID II Directive are intended to correct these conditions and foster the development of a more open, transparent and competitive market structure to replace the “two-tier” market. This in turn is essential to realising the G-20 objective of promoting transparency, efficiency and competition in the OTC derivatives markets. However, to realise these goals and objectives, further explicit action on “non-discriminatory access” is needed, and HMT’s proposed implementing legislation for the OTF regime provides the means to do so.

In Citadel’s view, effective enforcement of the “non-discriminatory access” principle set out in Article 18(3) of the MiFID II Directive is key to the successful implementation of the MiFID II trading obligation for derivatives and to encouraging trading on transparent marketplaces. As noted above, Article 18(3) of the MiFID II Directive requires trading venues (including OTFs) to put in place “transparent and non-discriminatory rules, based on objective criteria, governing access to, or membership of” the venue, and we note that HMT has proposed explicitly applying this standard to OTFs that are run by recognised investment exchanges via its draft Financial Services and Markets Act 2000 (Recognition Requirements) Regulations 2001. Citadel welcomes that this principle will clearly be enshrined in UK legislation as a result.

Nevertheless, we consider that this high-level “non-discriminatory access” standard would benefit from further detail in the UK implementing legislation. In our view, the Level 1 text of the MiFID II Directive alone may lack the specificity needed to effectively ensure compliance with the fundamental principle of “non-discriminatory access”. While ESMA has been tasked with determining what information OTF operators need to submit to their national competent authorities in order to become authorised under the MiFID II regime (indeed, based on ESMA’s draft

proposals, OTF operators will need to submit “rules and procedures to ensure...objective and non-discriminatory access”), ESMA does not have a mandate to determine what exactly “non-discriminatory access” means in this context. In the interests of legal certainty, and ensuring that OTF applicants understand the conditions that their rulebooks must meet prior to applying for authorisation, we consider it vital that UK authorities further define the “non-discriminatory access” principle.

The “non-discriminatory access” principle warrants further definition given the substantial market structure and trading reforms that are being introduced by both EMIR⁸ and the MiFID II regime. Given that the combination of the EMIR clearing obligation and the MiFID II Regulation⁹ (“MiFIR”)’s straight-through-processing (“STP”) requirements will remove bilateral counterparty credit risk as a relevant consideration when trading cleared OTC derivatives, legacy trading venue access requirements limiting who can and cannot transact with each other are rendered obsolete. Meanwhile, the introduction of the trading obligation for certain derivatives under MiFIR will compel a much broader array of market participants to use trading venues when trading derivatives. Artificial barriers to accessing such trading venues not only undermine the trading obligation, but also compromise market participants’ ability to secure best execution.

Related trading reforms to be implemented under the MiFID II regime will also create a renewed need to consider the principle of non-discriminatory access. For example, Article 17(3) of the MiFID II Directive introduces an obligation for investment firms engaged in algorithmic trading and pursuing a market making strategy to carry out market making “continuously during a specified proportion of the trading venue’s trading hours”. In its Consultation Paper on MiFID II/MiFIR of 19 December 2014¹⁰, ESMA proposed that a firm will be considered to be pursuing a market making strategy in this sense if it is posting firm, simultaneous two-way quotes of comparable size and competitive prices in at least one financial instrument on a single trading venue for no less than 30% of daily trading hours during one trading day. This is a relatively low threshold, and although it may be revised in the final technical standards, firms may well choose to limit their trading around whatever threshold is ultimately implemented in order to avoid being treated as market makers. This will cause liquidity to move away from the relevant venue, with an accompanying risk of fragmentation; as such, there will in future be even more of a need for the deeper liquidity that all-to-all marketplaces would bring. In addition, if more firms are to be classed as market makers, they will need marketplaces that allow them to effectively offset their risk on an ongoing basis, and effective enforcement of the non-discrimination principle will help with this.

⁸ Regulation (EU) No 648/2012.

⁹ Regulation (EU) No 600/2014.

¹⁰ ESMA Consultation Paper on MiFID II/MiFIR dated 19 December 2014, available at: http://www.esma.europa.eu/system/files/2014-1570_cp_mifid_ii.pdf

The importance of further defining “non-discriminatory access” is also evidenced by recent experience in the U.S. markets with the introduction of swap execution facilities (“SEFs”) for OTC derivatives trading. Notwithstanding requirements under the Dodd-Frank Act and Commodity Futures Trading Commission (“CFTC”) rules that SEFs offer “impartial access”, a standard that parallels the MiFID II “non-discriminatory access” principle, many market participants encountered an array of barriers to accessing certain SEFs, some of which persist today. In response, the CFTC has had to devote considerable time and resource to investigating and remedying various SEF rules, policies and procedures that violate the “impartial access” principle. By further defining “non-discriminatory access” in the UK implementing legislation, HMT could avoid similar pitfalls and ensure a more successful implementation of trading on OTFs .

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We appreciate the opportunity to provide comments on the Consultation. Please feel free to call the undersigned at +44 20 7645 6821 with any questions regarding these comments.

Respectfully,



Eva Sanchez
General Counsel, Citadel Europe