



EUROPEAN CENTRAL BANK

EUROSYSTEM

EUROPEAN COMMISSION'S PUBLIC CONSULTATION ON THE REVIEW OF THE MiFID – EUROSYSTEM CONTRIBUTION

On 8 December 2010 the European Commission published a consultation paper on the review of the Markets in Financial Instruments Directive (MiFID)¹ with the aim of preparing a formal legislative proposal in spring 2011. This note provides the views of the Eurosystem regarding issues raised by the Commission's consultation paper that are of particular importance for financial stability (following the order of the sections in the paper). This is without prejudice to the views to be expressed by the Eurosystem once the ECB is formally consulted on the legislative proposal.

I GENERAL COMMENTS

In general the Eurosystem supports the Commission's initiative to review the MiFID, which is timely for a number of reasons. First, although, in general, the MiFID's overall framework proved to be conducive to allowing more competition among trading venues and better protection for investors, a review is warranted in the light of new market developments and the experience gained through the financial crisis. In particular, the Eurosystem strongly supports the enhancement of the regulatory framework as regards OTC derivatives, which is in line with international recommendations and inspires other parallel regulatory initiatives from the Commission, such as the proposed regulation on OTC derivatives, central counterparties and trade repositories.

Second, the new European System of Financial Supervision (ESFS), composed of the European Supervisory Authorities (ESAs) and the European Systemic Risk Board (ESRB), and supported by the ECB, has now started to operate. The potentialities of the new

institutional framework, which constitutes a decisive step forward in the coordination of regulation and supervision at the EU level, should be fully exploited in the review of the MiFID.

Third, it is noted that the introduction of reporting requirements is a main objective of both prospective legislative acts, the MiFID and the proposed regulation on OTC derivatives, central counterparties and trade repositories, each applying to various types of assets and/or institutions. While the general direction of establishing reporting requirements is positively acknowledged from the perspective of competent authorities, the consistency of reporting requirements has to be ensured with a view to avoiding any overlaps or gaps. Thus, there is a need to streamline the reporting requirements across the legislative proposals, as these continue to develop in parallel.

2 ADDRESSING DEVELOPMENTS IN MARKET STRUCTURES (SECTIONS 2.2, 2.3 AND 2.6)

ORGANISED TRADING FACILITIES

The Eurosystem supports the Commission's intention of rethinking the overall regulatory framework, taking into account the emergence of alternative trading facilities and, in general, the new developments in the financial markets, and spurred also by the enhanced competition triggered by the MiFID. In this context the proposal to introduce a new category of organised trading facilities – subject to general requirements and, in particular cases

¹ The Commission's document focuses on Framework Directive 2004/39/EC, while outlining possible changes that may follow to the implementing directive (Directive 2006/73/EC) and the implementing regulation (Regulation (EC) No 1287/2006).

(e.g. the crossing systems), to additional requirements – is an option to be further explored. Alternatively, the Commission may consider realigning the existing three categories of Regulated Markets, Multilateral Trading Facilities (MTFs) and Systematic Internalisers to include newly-evolving trading venues.

As regards the proposed general requirements, especially the proposed notification to the competent authorities of the trades that can be executed on the facility, the range of financial instruments that are available, the arrangement for post-trade processing and the requirement that all trading venues should be monitoring trades with a view to identifying market abuses seem particularly appropriate.

TRADING OF STANDARDISED OTC DERIVATIVES ON EXCHANGES OR ELECTRONIC TRADING PLATFORM

The Eurosystem notes that urgent action must be taken to implement in the EU the G20 commitment reached in September 2009, namely that “*all standardised OTC derivative contracts should be traded on exchanges or electronic trading platform, where appropriate, and cleared through central counterparties by end-2012 at the latest*”. This is with a view to improving transparency in the OTC derivatives markets, mitigating systemic risk and protecting against market abuse. To avoid regulatory arbitrage, such a move should be conducted while having regard to the principles under discussion at the international level.²

In this context, the Eurosystem supports the proposed introduction in the MiFID of a legal requirement that eligible OTC derivatives should be traded on trading venues. As regards the elements of the Commission’s proposal, the Eurosystem has the following comments.

First, it is proposed that trading of a derivative moves to electronic platform trading when it is suitably developed. Developments in this respect may be identified in terms of the liquidity or frequency of trades. A cautious approach

to determining such suitability is needed. The definition of sufficient market liquidity should take into account the information provided by the market operators. In order to achieve progress towards the objectives indicated by the G20, the MiFID requirements should support and underpin a process led by the European Securities and Markets Authority (ESMA) with ambitious targets for an increased level of legal and product standardisation and for the progressively higher use of an organised venue for the trading, also taking into account the respective work undertaken by IOSCO.

Second, as regards the characteristics of the trading facilities, the Eurosystem notes that they should fulfil high standards with regard to market transparency and operational efficiency, such as those set out for regulated markets and MTFs. When defining the characteristics to be fulfilled by other organised trading venues to ensure a level playing field and avoid regulatory arbitrage, close attention should be paid to the work conducted at the international level, in particular by IOSCO.³

SME MARKETS

Under the current MiFID, specialised small and medium-sized enterprises (SMEs) exchange markets (e.g. Alternext in France, Belgium and the Netherlands) are not specifically regulated. The Commission proposes to introduce both a precise definition of SME markets and a tailored regime for SME markets

2 On 25 October 2010 the FSB published a Report on Implementing OTC Derivatives Market Reforms, which sets out recommendations on the implementation of the G20 objectives.

3 According to the Recommendation 13 of the FSB Report, IOSCO should conduct an analysis by 31 January 2011 of: (i) the characteristics of the various exchanges and electronic platforms that could be used for derivatives trading; (ii) the characteristics of a market that make exchange or electronic platform trading practicable; (iii) the benefits and costs of increasing exchange or electronic platform trading, including identification of benefits that are incremental to those provided by increasing standardisation, moving to central clearing and reporting to trade repositories; and (iv) the regulatory actions that may be advisable to shift trading to exchanges or electronic trading platforms.

under the framework of regulated markets and MTFs, with specific requirements regarding organisational, trading and transaction rules. This proposal is welcome in principle as one more step towards adopting a more coherent strategy towards SMEs in the policy-making process at the EU level.

Overall, a number of benefits could derive from the definition of a harmonised and tailored regime for SME markets. First, it could promote the creation and harmonisation of a network of markets specialised in SME financing in Europe. This would provide a nursing ground for small companies to expand until they are large enough for the main market, would help to maintain the commercial viability of small companies through economic cycles by providing them access to capital, and would stimulate regional economies and ensure alternative paths for capital intermediation. As long as these specialised stock markets have low barriers of entry and simplified rules, compared with traditional stock exchanges, they would facilitate the equity issuance process, which is currently partly hindered for SMEs by the lack of harmonisation in the EU internal market. Second, from the SMEs' perspective, seeking a listing may be beneficial for questions of future development, management succession, diversification of funding and greater commercial visibility. Third, the data collection process of the SME-related information is currently scattered around the banking system, credit guarantees schemes and other programmes. Encouraging the creation of specialised markets would also help to build a credible SME information system that would allow for comparability of financial data across borders, increase credibility and, eventually, provide better protection for investors.

Finally, the Commission proposes that the definition of listed SMEs would depend on both the traditional EU definition of SMEs (i.e. based on the number of employees and either total assets or turnover thresholds) and market capitalisation. The introduction of the latter

criterion makes sense to the extent that it takes into account the diversity of financial markets in the EU. Hence it should not be a fixed amount, but, as proposed, a percentage of the average market capitalisation of the domestic Member State. This would also put European practices broadly in line with those of the United States. An additional criterion could be needed for those firms which are issuing equity for the first time. It could be based on a threshold based on the amount of funds raised.

AUTOMATED TRADING

In the last few years, automated trading, and in particular High-Frequency Trading (HFT), has experienced strong growth.⁴ Such a development may trigger a number of risks for orderly trading and for financial stability. First, the existence of players with very short horizons may lead to the prices in the markets being driven by short-term objectives and may therefore reflect fundamentals less efficiently. Second, the high number of orders generated by HFT may put market infrastructures under severe stress. Third, while HFT are often mentioned as providers of liquidity in the markets, unexpected stress situations may lead them to a sudden withdrawal with lasting liquidity disruption. Finally, given the massive number and the high frequency of orders, errors by HFT may lead to disorderly trading or even a breakdown of trading systems.

In this context, the Eurosystem supports the Commission's proposal for making HFT above of stress are welcome, as a means of controlling the spillover of tensions across assets and of boosting liquidity if the emergence of turbulences should lead to a sudden stop in trading, as decided by the underlying algorithm. However, further assessment is required to establish whether market participants that have a large weight in overall transactions

⁴ According to CESR, estimates of the HFT's significance in the markets (provided mainly by trading platforms) varies from 12% to 40% of total trading (CESR Technical Advice to the European Commission in the Context of the MiFID Review – Equity Markets, 29 July 2010, par. 201).

at good times should also engage in trading when markets become more unsettled, as market-makers are currently fulfilling this function. Finally, a minimum resting time for orders entered into the order book may be contemplated.

3 IMPROVEMENTS TO PRE- AND POST-TRADE TRANSPARENCY (SECTION 3.4)

The Eurosystem reiterates its broad support for the overall regime for pre- and post-trade transparency introduced by the MiFID. Already at the time of the adoption of the MiFID, the Eurosystem had called for a consolidation of information at the European level in order to facilitate price comparisons. Moreover, the ECB noted that extending the scope of transparency obligations to both debt securities (frequently traded on non-regulated markets) and shares would have increased the efficiency of the price formation process and preserved market integrity.⁵

Against this background, the Eurosystem supports the Commission's proposal to amend the MiFID framework directive to require pre- and post-trade transparency for all trades in specific non-equity products, whether executed on regulated markets by MTFs, by organised trading facilities, or by OTC. The ECB supports this view with the following arguments.

Insufficient transparency on asset-based securities (ABSs) is widely believed to have contributed to exacerbating the crisis and delaying the normalisation of ABS markets. The need to increase transparency in these markets has become particularly clear during the crisis. Following significant support by the market participants received in a public consultation in early 2010, the Eurosystem launched the final preparatory work on the establishment of loan-level information requirements for ABSs in its collateral framework in April 2010. The objective of this initiative is to enable better risk assessments and increase confidence in the securitisation markets.

In December 2010 the Governing Council of the ECB decided to establish loan-by-loan information requirements for ABSs in the Eurosystem collateral framework. The Governing Council intends to introduce the loan-by-loan information requirements approximately within the next 18 months from that date, first for RMBSs and thereafter gradually for other ABSs.

The lack of sufficient pre- and post-trade arrangements on other non-equity assets, such as CDS contract and other types of OTC derivatives, may not have been the *cause* of the turmoil, but most likely contributed to exacerbate the recent financial meltdown. Its complexity and size reinforced the potential for excessive risk-taking.

Therefore, the ECB would welcome regulatory-driven trade transparency regimes since, in particular, post-trade transparency in Europe has mainly been left in the domain of self-regulation without sufficient results. Both pre- and post-trade transparency are equally important respectively to ensure and monitor best execution. Information always leads pricing. Hence, pre-trade transparency can be seen as a logical prerequisite for post-trade data.

At the same time, including all bonds executed on different market places would avoid the risk of de-listing, which would have the adverse effect of reducing market transparency and also information on the bonds.

In general, enhanced transparency would be a valuable source of information for market participants as it could facilitate portfolio valuation by improving the price discovery process and reducing information asymmetries between the buy-side and the sell-side, as well as reducing market volatility. It could also support better risk management practices. Ultimately, it may also reduce risks in liquidation processes. Many market

⁵ ECB Opinion CON/2003/9, which is available on the ECB's website.

participants are however somewhat reluctant to introduce trade transparency obligations for non-equities markets. This position is mainly based on the argument that increased trade transparency has negative liquidity effects and therefore undermines market efficiency. However, empirical studies that analyse the effects of trade transparency on equities and non-equities markets mainly show evidence for the positive aspects of trade transparency. Negative aspects, such as slower execution speed or evasive movements to other securities market segments, could also be found, but a dramatic decrease in market liquidity could not be observed. In addition, there is a broad consensus among investors that more transparency is needed to improve investor protection and enhance market integrity.

A new pre- and post-trade transparency regime on non-equities would be welcome. However, a post-trade transparency regime needs to be introduced very carefully, taking into account asset class characteristics (as mentioned in the consultation paper) as well as jurisdictional characteristics with the aim of having a harmonised EU-wide regime to keep the level playing field.

4 DATA CONSOLIDATION (SECTION 4)

The Commission raises a number of questions relating to data consolidation and points to specific challenges in this respect. These challenges relate to: (i) the need to improve the quality and consistency of raw trade data, ensuring that they are provided in a consistent format (i.e. to facilitate consolidation); (ii) reducing the cost of post-trade data for investors; and (iii) introducing a consolidated tape for the EU market. Concerning the quality and consistency of raw trade data, the Commission proposes an amendment to the MiFID framework directive to require all firms who execute transactions to publish their trade reports through an Approved Publication Arrangement (APA). The Commission sets out a number of possible conditions for an APA,

including that it could be a regulated market, an MTF, an organised trading facility or another organisation (e.g. a trade repository).

The Eurosystem welcomes any efforts to improve the quality and accessibility of financial information, including information on pre- and post-trade. In this context, the Eurosystem welcomes the proposal for a European consolidated tape, defined as an integrated reporting system, which would provide a single point of access for post-trade information. Indeed, information collected for transparency purposes (in particular, post-trade information) may be used for multiple purposes and, if bundled with other available datasets (in some cases, already stored in other databases such as registers of entities, of credit risk or of securities⁶), they provide further value added. This would allow a maximum use of such information and, at the same time, would minimise the reporting burden. Unfortunately, an analytical approach, building on the combination of different pools of micro-data is currently not feasible,⁷ mainly due to the lack of data standardisation. Therefore, the consultation document points in the right direction as it stresses the need for the European consolidated tape to harmonise the type of information to be included as well as the format. In this respect, the Eurosystem notes that improvements

6 In this vein, several initiatives are under way or already exist. Databases on entities comprise: i) the ongoing work of the Commission concerning business registers (see the European Commission's recent Green Paper on "The interconnection of business registers" (COM(2009) 614 final), which sets out proposals for ensuring better access to company information through the interconnection of business registers in Europe"); ii) the Regulation on Business Registers for statistical purposes and the related Euro-Group Register; iii) the ECB's Register of Institutions and (Eligible) Assets Database; and iv) the forthcoming work mandated to the newly-established European Supervisory Authorities to set up a register of intermediaries. In addition, databases on securities comprise: i) the Instrument Reference Data System (MiFID database); ii) the ECB's Centralised Securities Database; and iii) possible future progress on implementing an interactive database for information to be disclosed under the Prospectus Directive.

7 These practices result in an overwhelming amount of information and a huge administrative burden for companies, and represent a major barrier to the use of information technology, to efficient and effective processes and to the multi-purpose use of such information.

in the service can be achieved, in particular, if priority is given to the implementation of well-defined and interactive data-reporting (i.e. based on a standard data formats). Such reporting represents a key capability for allowing efficient and flexible access to consolidated post-trade information. However, the establishment and enforcement of precise standards setting out the details will be essential to improve the quality of raw data.

5 MEASURES SPECIFIC TO COMMODITY DERIVATIVE MARKETS (SECTION 5)

The Eurosystem broadly supports the proposed initiatives on commodity derivatives markets. From the Eurosystem's point of view, it would be important to introduce sufficiently detailed and high-frequency information on positions held by various categories of traders to properly assess how activity in derivatives markets affects physical commodity prices. Given the electronic nature of most commodity markets, this would not constitute a big burden. Also the categorisation of traders could be well based on the use of the EU regulatory classifications. Furthermore, distinguishing positions on the basis of their hedging purposes may help to gain more insight into the character of the transaction.

Finally, in order to require organised commodity derivative trading venues to design contracts in a way that ensures convergence between futures and spot prices as well as for the introduction of limits to how much prices can vary in a given timeframe, we think it is unclear how such convergence could be achieved besides measures aimed at facilitating arbitrageurs on the physical markets (e.g. easy access to storage facilities). As regards limits to price fluctuations, we think that less invasive ways of curbing price volatility should be sought.

6 TRANSACTION REPORTING (SECTION 6)

The regime established by the MiFID on reporting requirements aims to ensure that the

relevant competent authorities are properly informed about transactions in financial instruments. The Eurosystem welcomes the proposed extension of the scope of transaction reporting requirements, which would underpin the proposed extension of the powers of competent authorities with the review of the Market Abuse Directive. The information collected would be also beneficial in supporting the ECB's tasks.

In addition, the consultation document suggests amending the framework directive so that transaction-reporting includes the means of identifying the person who has made the investment decision (i.e. a client identifier). The Eurosystem considers the inclusion of client information to be important, especially for legal entities that hold securities, as it represents elementary information for assessing risk to financial instability and for monitoring market abuse. In this respect, the Eurosystem stresses the importance of working towards a unique identifier of legal entities as a key tool that would allow information to be processed quickly. Moreover, the use of such identifiers, along with the development of business registers providing information on the group composition of legal entities, is a prerequisite for responding to ad hoc information demands (e.g. on the concentration of securities holdings, financial interconnectedness or market abuses). Along these lines, the proposal to allow direct reporting by investment firms to a reporting mechanism at the EU level that would ensure an EU database permanently accessible to competent authorities is also welcome, as such flexibility in responding to demands increases the quality and timeliness.

As a final remark, the Eurosystem notes that the availability of standard transaction information needs to be ensured at the level of details necessary for the performance of the tasks of certain authorities. The legal requirement for exchanging information is already adequately enshrined in Article 58(5) of the MiFID as recently amended by Directive 2010/78/EU of the European Parliament and of the Council

amending various directives (the so-called Omnibus Directive).⁸ The necessity of such an exchange may comprise confidential information reported in the context of the transaction reporting. Such information may enable authorities such as the ECB and the NCBs, the ESMA, the EBA and, in general, supervisors and the ESRB to perform their respective tasks in monitoring and cross-checking developments with information stored in other databases, thereby allowing a proper and timely analysis of financial stability and systemic risk.

7 INVESTOR PROTECTION AND PROVISION OF INVESTMENT SERVICES (SECTION 7.2)

The protection of investors is essential for preserving market confidence and therefore for fostering financial stability. As shown during the financial crisis, it is very important to improve the transparency of financial products and the understanding of the degree of complexity. Therefore the Eurosystem supports the Commission's proposal for further clarification and enhancement of the MiFID provisions related to the provision of information to clients in Section 7.2. With specific regard to the proposed requirements on complex products, the Eurosystem agrees that intermediaries should inform clients about the basis on which advice is provided and generally advise clients by: i) considering a sufficiently large number of financial instruments available on the market, notably financial instruments of different types and from different providers; and ii) ensuring, prior to the transaction, that a risk/gain and valuation profile of the instrument in different market conditions is carried out. As regards the latter condition, it would be advisable that, in such a valuation, the risk per unit of return of the selected instruments is provided relative to a couple of well-known benchmarks (e.g. a Treasury bond of a comparable maturity and a broad equity index). In the same way worst case scenarios should also be included in the comparison so that investors can perceive the "distance" between standard

and well-understood assets and complex financial instruments in a proper way under any market conditions.

Finally, the Eurosystem supports the Commission's proposal as regards the limitation of the eligible counterparty regime. Indeed, experience has shown that the related presumption that certain entities, such as municipalities, have the necessary level of knowledge to acquire complex instruments is not realistic and may lead to serious losses that, in extreme cases, could even weaken the fiscal situation of Member States.

8 REINFORCEMENT OF KEY SUPERVISORY POWERS (SECTION 9)

The consultation paper mentions the intention of introducing into the MiFID the possibility for the Commission to ban the provision of investment services and the carrying-out of investment activities in certain financial instruments in certain circumstances where there are concerns over investor protection or a threat for the orderly functioning of financial markets or the stability of the financial system. A similar power would be given to national regulators, under the coordination of the ESMA. The Eurosystem notes that the financial crisis showed the need for competent authorities to have all the powers necessary to be able to react quickly in an emergency situation. However, similar powers to temporarily prohibit or restrict certain financial activities are already attributed to the ESAs when an emergency situation is declared by the Council, in consultation with the Commission and the ESRB.⁹ Therefore, further clarification is needed as regards the precise scope and conditions of the intended new power to ban, which should eventually become part of a general framework ensuring a coordinated approach.

⁸ OJ L 331, 13.12.2010, p. 84.

⁹ Articles 9 and 18 of the regulations establishing the European Supervisory Authorities.

The consultation paper also mentions that the framework directive could be amended to:

- (i) provide competent authorities with further harmonised powers to request information on positions in derivatives and to order the reductions of the positions on the ground of investor protection or market integrity; and
- (ii) allow for the adoption of implementing measures setting ex-ante position limits for derivatives contracts.

Indeed, tensions in bond markets during the financial crisis raised concerns that manipulative speculation with derivatives may have played a role in triggering an increase in the borrowing costs in some countries. In this context, the Eurosystem supports the intended enhancement of the monitoring by competent authorities of positions in derivatives, which would be very important, both for micro- and macro-prudential supervision. As regards the Commission's proposal of entrusting regulators with the power of setting position limits for derivatives contracts, they can be certainly part of a wider toolbox available to public authorities. However, such tools should be used in a careful way, so as not to impair market liquidity, and in a coordinated manner to avoid regulatory arbitrage.

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Address:

Kaiserstrasse 29,
60311 Frankfurt am Main,
Germany

Postal address:

Postfach 16 03 19,
60066 Frankfurt am Main,
Germany

Telephone:

+49 69 1344 0

Website:

<http://www.ecb.europa.eu>

Fax:

+49 69 1344 6000

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