

Are changes required in on-going evolutions of EU securities infrastructures in the light of the financial crisis?



Two years since the MiFID Directive and the Code of Conduct have come into force, it is time for a first review taking stock of the benefits and impacts of these measures, particularly for investors and issuers¹. This will enable to identify the necessary actions that EU institutions should take to further foster

efficiency and safety of securities markets in the future. The review of the MiFID Directive programmed by the Commission in 2010 will be part of this exercise.

In addition, the review of MiFID should investigate how the resilience of EU securities infrastructures, demonstrated during the recent episodes of the crisis², can be used to facilitate the return to stability and growth of European securities markets and define the conditions necessary to maintain such resilience and safety for users in a more interconnected and competitive landscape following the implementation of MiFID and of the Code of Conduct.

The role that securities infrastructures can play in ensuring greater transparency of capital markets should also be used to accelerate the return of confidence in such markets.

1. Competition has developed in the trading and in the clearing space with MiFID and the Code of Conduct but this has benefited mainly sophisticated investors and blue chip stocks so far.

Developing competition among EU securities infrastructures was chosen by the Commission to accelerate the reduction of prices of trading and post-trading services. The objective was also to favour further consolidation and/or specialisation over time, bringing potential economies of scale³, but without a predetermined target model.

The entrance of new players in the trading and clearing spaces – MTFs (Multilateral Trading Facilities) and SIs (Systematic Internalisers) and the central counterparties (CCPs) they use – has had positive effects on the services and options offered to investors, particularly sophisticated ones (e.g. high frequency traders), as well as on the market prices for blue chip stocks, which are the main focus of MTFs. However more coherent rules remain to be implemented across EU trading venues and CCPs to increase the efficiency of competition while maintaining an adequate level of safety of capital markets in this new environment.

2. Level playing field and transparency issues remain to be solved in the implementation of the MiFID Directive on the trading level:

- Definitions of alternative trading venues - MTFs and SIs - given in the Directive may need to be better interpreted or possibly reviewed to make sure they cover all existing business models with similar features. These definitions should also keep pace with on-going technological innovations. The same functions should indeed be covered by the same

rules to avoid regulatory loopholes or arbitrage that can potentially create risks and reduce investor confidence.

- Transparency requirements related to best execution (pre-trade transparency) should be improved for OTC transactions on standardized products and extended for Systematic Internalisers (SIs), according to some players. Some in addition also consider that MiFID could be extended to include instruments which are not covered at present, such as certain types of bonds, taking into account their specific features. Some observers nevertheless point out that this review should take into account investor needs and that best execution rules are primarily designed for retail investors.
- Increased cooperation among supervisors and a more active role of CESR could potentially help in analyzing and solving differences in supervision and regulation between EU member states and between regulated markets and MTFs that lead to possible competitive distortions or supervisory loopholes. These differences may impact the cost structures of providers that are more strictly regulated and create an unlevel playing field among providers. New surveillance processes could also be needed to monitor markets made more volatile by the development of algorithmic trading and more complex due to the fragmentation of trading.

The benefits brought by MiFID to different types of investors and issuers should be evaluated in greater detail. In addition solutions for reducing the potentially negative impacts of the fragmentation of liquidity created by MiFID on costs for users and on the quality of data accessible to investors and issuers should be more closely evaluated: for example enforcing consistent rules for disclosing market data or evaluating more precisely the evolution of total costs for users. Finally the impacts of non regulated dark pools on price formation and on transparency for different market stakeholders need to be examined in greater detail⁴.

3. More specific and consistent risk management rules and stricter enforcement are required in the clearing space to ensure efficient and safe competition

- For competition to be meaningful interoperability still needs to be more widely implemented, Interoperability among CCPs is necessary to ensure efficient competition between providers, allowing users potentially to choose one CCP to clear all their trades and to obtain netting benefits and collateral optimizations. This requires that trading venues allow users to choose among multiple CCPs and that certain legal barriers be lifted. Two pre-conditions are necessary to put interoperability among CCPs in place in a safe and efficient way:

- Interoperability needs to be safe for users. This means defining precise and common minimum standards for inter-CCP risk management adapted to the new competitive environment fostered by MiFID and the Code⁵ and ensuring the coherent enforcement of the standards throughout EU central counterparties. CCPs indeed operate at present with different risk management approaches and practices. Interconnection among CCPs creates new inter-CCP exposure that needs to be adequately mitigated. Transparency to regulators, trading venues and users in how interoperating CCPs manage their

¹ Benefits brought by MiFID to different types of end investors (retail, high net worth, corporates) and to different types of issuers (blue chip included or not in the indices, Mid and small caps...)

² They have continued performing their essential functions to mitigate counterparty risk during the crisis without incurring losses themselves due to credit or operational problems

³ Consolidation remains partial in the EU due in particular to the coexistence of different horizontal and vertical business models

⁴ Around 40% of the order flow in Europe is considered to be processed OTC with a large proportion on unregulated crossing systems or non MTF dark pools which offer investors the possibility to exchange large blocks of securities but also execute smaller trades of securities anonymously and without prices being revealed until trades are completed

⁵ building on the existing recommendations of ESCB-CESR and EACH

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11 bis, rue Mansart - 75 009 Paris - FRANCE - Tel.: +33 1 40 82 96 03 - Fax: +33 1 40 82 96 03 - www.eurofi.net

exposure to each other should help mitigate risks and encourage best practice in the absence of common minimum standards.

- Competition among CCPs should not lead to lower risk management standards or to significant differences in standards proposed to users within a given CCP. This means imposing common minimum risk standards throughout the EU. CESR should also make sure that competing entities are supervised in a similar manner. CCPs could indeed be tempted to reduce investments in risk management and to converge towards the minimum risk standards allowed by EU regulators (e.g. on the level of collateral...) if common standards are not put in place. The consequence could be to bring the overall level of safety down. There are also public policy implications if some CCPs are potentially too important to fail.
- Making sure that the current secured risk management practices of CCPs for cash equities are not jeopardized by new processes linked to interoperability or practices to foster competition is essential at a time when projects are under way to extend CCPs to other products, particularly OTC ones.
- The 2010 MiFID review should provide the opportunity to analyze the potential repercussions of the on-going evolutions in clearing on the competitiveness of trading venues⁶ and to verify the efficiency and safety of competition created in the clearing space and its impacts for investors e.g. in terms of prices. The MiFID review or a specific consultation should also enable to examine the overall business case of interoperability which requires complex legal agreements and operational arrangements and many links to be developed among CCPs⁷. This may lead to additional costs ultimately borne by users that may not be totally offset by the benefits brought by competition. The cost impacts of the concentration of clearing flows which should normally result from interoperability should also be analyzed for local or regional participants⁸. Some players also believe that the statutes, prudential standards and supervision of CCPs should be reviewed in this new environment to ensure sufficient safety. Others suggest that the experience gained in the T2S project (Target 2 Securities) could potentially serve as a source of inspiration in the clearing area.

4. Securities infrastructures should be further developed and leveraged to ensure the systemic safety of securities markets and other financial markets, particularly OTC derivative markets:

In general terms there are risk mitigation and transparency benefits in having central core financial market infrastructures rather than multiple links between market participants. There is scope for a further review as to whether certain aspects of financial market activity would benefit from the creation of additional infrastructure or expanded infrastructure functionalities.

The suggestions recently made by the EU authorities for CDSs (Credit Default Swaps) in particular should be further analyzed and possibly expanded to other products.

- Beyond CDSs for which two central counterparties operate at present

in the EU, the benefits of imposing CCPs on all OTC products which pose systemic risk and have market prices and sufficient liquidity, should be further evaluated by the EU authorities. Some observers however point out that this objective should not prevent users from having access to custom-made contracts⁹, addressing specific risks, if this does not create systemic risks.

- A consistent and centralized approach to regulatory data reporting through a data repository covering OTC derivatives transactions seems necessary to facilitate the monitoring of systemic risks by EU regulators and the future EU Systemic Risk Council. Such a solution could enable regulators to monitor positions of all types of OTC products.- CCP eligible and non-CCP eligible ones. Global solutions that satisfy EU level requirements in terms of access to EU regulators and governance should be favoured for markets which have a global dimension to avoid overlapping warehouses¹⁰.
- The opportunity of setting up of a centralised securities data utility, as suggested by the ECB, which could simplify data quality management processes by providing reference data on securities in a centralised and harmonised way should also be further explored.
- Trading platforms can also be leveraged to increase the transparency, efficiency and safety of order execution for standardized products.

5. Evolutions in the legal and market practice context of EU securities infrastructures should also be considered to improve the efficiency of EU post-trading infrastructures:

Work should continue in parallel on lifting the legal and fiscal barriers across EU markets and on implementing more consistent operational practices for post-trading in order to improve the efficiency, liquidity and safety of EU capital markets as well as to reduce risk and to increase legal certainty with respect to securities holdings.

Realising the cost reductions and efficiency gains across Europe projected with the ECB's Target 2 Securities (T2S) project, scheduled for implementation in 2013 will depend both on the extent to which national markets and central banks agree to adopt T2S and also on the extent to which national and market practices are harmonized in the T2S model.

Specific areas of focus should include:

- A harmonisation and a possible shortening of standard settlement cycles will have risk as well as conceivably cost benefits, to be weighed against potential operational complexities eg in handling orders originating from different time zones.
- Further work on the legal context of securities holdings in the perspective of the announced Directive, as well as on market practices related to securities holdings will have benefits in reducing risk, improving legal certainty and in eliminating restrictions that limit the practical ability of end investors to exercise their rights (corporate actions, voting at general assemblies, etc...).
- T2S-related harmonisation in fields such as account structures, collateralisation procedures and fails management.

⁶ In particular in the competition between exchanges using incumbent CCPs and alternative platforms using new clearing providers

⁷ Some players indeed remain convinced that benefits of competition should be measured against the costs, complexity, time required and risk of implementing competition in the clearing space in particular and that alternative scenarios could be considered on the occasion of the MiFID review. Complexity comes from legal certainty of risk management arrangements and the negotiations to agree on operational aspects when 2 CCPs treat an operation in different ways (eg how partial deliveries are handled)

⁸ Interoperability should enable users to clear all their trades through one CCP of their choice. Small / medium participants will have to cover part of the interoperability costs in this context which might be disproportionate to the benefits they may get out of interoperability on a domestic or regional level.

⁹ Which may play a role in the overall risk mitigation of certain markets.

¹⁰ Several repositories could potentially operate in the EU but on different product segments as an alternative, provided the business case is adequate.

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