EU securities infrastructures and derivatives markets in a global context

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Derivatives are a major focus of EU regulatory projects at present following the G20 commitments to increase transparency and counterparty risk mitigation of OTC derivatives transactions after the financial crisis. Measures have also been proposed by the Commission to regulate short selling in a harmonized way across the EU in order to give regulators the necessary data and powers to put in place actions to prevent the volatility effects and the amplifications of price falls observed during the crisis.

These measures aimed at improving the safety and stability of EU capital markets are due to be applied from July 2012 onwards and are in line with similar reforms undertaken in other regions in the world eg in the US. They will complete on-going regulatory reforms and market-driven initiatives mainly focused on increasing efficiency and reducing fees of EU securities infrastructures, particularly for cash instruments: MiFID for trading which will be reviewed in 2011 and the Code of Conduct, the T2S (Target 2 Securities) project and the removal of the Giovannini barriers in the post-trading area.

All the measures mentioned above also share a common objective of contributing to restore investor confidence and will be completed by a review of investor protection rules in MiFID for securities and by the PRIPs initiative (Packaged Retail Investment Products) envisaged by the Commission to improve information and distribution rules for investment funds, life insurance and structured products.

1. The reform of derivatives markets is under way in Europe following G20 guidelines:

The crisis was not caused by the derivatives markets but the huge exposures built up by AIG and Lehman in particular accelerated the effects of the crisis. This showed that the risks related to derivatives were not sufficiently mitigated, particularly in the OTC market where almost 90% of them are traded.

The opaqueness of OTC markets[1] prevented supervisors from being able to identify early the risks building up in the system, the extent to which risks were concentrated and also the effect that the default of major counterparties could have on the stability of the system. The lack of precise visibility on the overall exposure of major counterparties (i.e. the netted value vs. the notional gross amount) led to potential runs and freezing in the market until positions were wound down.

The EMIR Directive[2] proposal published in September 2010 by the Commission aims at improving the transparency of OTC derivatives transactions and reducing counterparty risk.

The main features of this proposal which covers all segments of the OTC derivatives market are in line with G20 requirements and with on-going reforms in the US:

a. **Mandatory clearing of CCP eligible contracts,** except for contracts issued by non-financial firms[3]:

- CCPs (central counterparties) manage counterparty risk by providing a guarantee to each party in a transaction, supported by adequate collateral and margin requirements, that the agreed transaction will be honoured even if the other party defaults.
- Eligible contracts will be determined either by ESMA (the new EU Securities and Markets Authority to be implemented in January 2011) or by the competent authority which has authorized the CCP to clear a class of derivatives
- To avoid CCPs becoming a source of risk to the financial system in themselves, the proposal introduces conduct of business, organisational and prudential requirements so that CCPs manage risk properly and are safe to use. Furthermore the authorisation of a CCP will be subject to that CCP having access to adequate liquidity (central bank and/or creditworthy and reliable commercial bank liquidity). Specific requirements are defined for CCPs entering into interoperability arrangements for cash equities (regulatory approval required, specific management of the extra risks).
- In order to preserve the global nature of OTC derivatives and avoid the erection of barriers CCPs should not be allowed to accept only transactions concluded on execution venues with which they have privileged relationships or which are part of the same group.

b. **Creating transparency through the reporting of post-trade information on all OTC derivatives trades to a trade repository** (except trades between two non-financial firms[4]):

- Counterparties must report the details of any derivative contract they have entered into and any modification thereof, including novation and termination, to a registered trade repository (entity that centrally collects and maintains the records of OTC transactions). The regulation proposes that the Commission be empowered to define the content, format and frequency of reports for different classes of derivatives following technical standards defined by ESMA.
- Trade repositories that wish to be used for the purpose of the reporting are required to register with ESMA which will ensure their surveillance
- Repositories will have to comply with strict requirements aimed at ensuring the confidentiality, integrity and protection of the information they receive and maintain. They must be established in the EU or meet a certain number of requirements to be defined by ESMA (regarding eg mutual exchange of information, access to data maintained...)

1. At present there is little reliable information on what is going on in the OTC derivatives market. There are no public prices available, no public information as to who is entering deals with whom, over what period of time, relating to what underlying asset or for which amounts
2. European Market Infrastructure Regulation
3.4. With non systemically important positions in OTC derivatives

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c. Additional requirements for trading contracts not deemed eligible to CCP clearing:

- For non eligible contracts which will continue to be managed on a 'bilateral basis'[5], the regulation requires the use of electronic means and the existence of risk management procedures with appropriate segregated exchange of collateral and proportionate capital for the counterparties involved.

The proposals of the EMIR Directive regarding OTC derivatives are due to be completed by other measures planned for 2011, notably:

- The revision of the CRD (Capital Requirements Directive) for differentiating capital charges between CCP cleared and non-CCP cleared contracts

- The revision of MiFID (see § 3. below): for ensuring trading of standardised contracts on organised trading venues and enhancing trade and price transparency across venues and OTC markets as appropriate

- The Market Abuse Directive: extending its scope to OTC derivatives.

2. Measures have been proposed by the Commission to avoid the negative effects of short selling experienced during the crisis:

Short selling (ie the sale of a security the seller does not own with the intention of buying it back at a later point in time in order to deliver it) became a sensitive issue in the EU in the context of market volatility in euro denominated sovereign bonds. Short selling positions through related CDS contracts were indeed accused of contributing to a decline of sovereign bond prices. Regulators had expressed earlier on during the crisis concerns about the effects of short selling amplifying price falls in distressed markets and potentially contributing to systemic risks. This had led a number of Member States to introduce emergency measures to restrict or ban short selling in some shares in autumn 2008. Specific concerns were also raised about naked short selling (ie when a short seller sells a financial instrument short without first borrowing it) which is considered by some observers to potentially endanger the stability of the financial system by exposing it to settlement risks, with an unlimited number of shares allowed to be sold in a short space of time.

Subsequently the Commission proposed in September 2010 a legislative framework to deal with these issues in a coherent way at EU level in order to improve the effectiveness of the domestic measures put in place and avoid regulatory arbitrage. The powers that national regulators have at present to restrict or ban short selling indeed vary to a large extent as well as the measures decided in the past.

This proposal addresses both short selling and CDSs since CDSs can be used to secure a position economically equivalent to a short position in the underlying bonds and includes 3 main types of measures:

a. Measures to improve transparency of short selling and CDS positions:

The measures put forward by the Commission aim at increasing transparency for regulators and markets and making it easier for regulators to detect risk in sovereign debt markets. Proposals require that all share orders on trading venues be marked as short (so called 'flagging') if they involve a short sale. In addition investors will have to disclose significant net short positions to regulators once these amount to 0.2% of the issued share capital of a company, and to the market at a higher 0.5% threshold. Concerning EU sovereign bonds, regulators will receive data on significant net short positions including those obtained through sovereign CDSs. In order to avoid any circumvention of these disclosure rules they also cover the use of derivatives to obtain a short position relating to the shares or bonds.

b. Harmonized powers of regulators and a coordinated EU framework:

National regulators would gain equivalent powers to restrict or ban short selling on a temporary basis in exceptional situations (following criteria to be defined by the EU Commission) in coordination with ESMA. ESMA will also be given the power to issue opinions to competent authorities when they intervene in exceptional circumstances and will have the possibility in some cases to adopt temporary measures itself.

c. Restrictions on naked short selling:

Measures proposed do not ban naked short selling but introduce limitations to this practice by imposing that investors, in order to enter a short sale, must either have borrowed the instrument concerned, entered into an agreement to borrow them, or have an arrangement with a third party to locate and reserve them for lending so that they are delivered by the settlement date (and at the latest 4 days after the transaction). In addition trading venues must ensure that there are adequate arrangements in place for buy-in of shares or sovereign debt, as well as fines and a ban on short selling, where there is a settlement failure.

These proposals build on practices existing in some member states and are considered by the Commission to be compatible with the principles outlined by IOSCO in 2009. The US have also reviewed recently rules regarding short selling. 'Flagging' of orders has been in place since 2004. A 'circuit-breaker' rule was adopted in February 2010 that restricts short sales of a share whose price has fallen by more than 10% compared to its closing price the previous day.

3. The upcoming MiFID review aims at taking into account recent evolutions in the trading market and correcting shortcomings of the present text

The evolutions triggered directly or indirectly by MiFID and by innovations in technology have led to major changes in the trading space. Competition has been successfully introduced between regulated markets (RMs) and alternative trading venues (and to a certain extent between central counterparties). This has brought benefits in terms of fee reductions and improved choice and services (eg with pan-European offers). But this has also led to more fragmentation in the market and created potential level playing field issues between venues subject to rules that differ to a certain extent.

Proposals have recently been made in particular by CESR and MEP K. Swinburne[6] in the perspective of the upcoming MiFID review scheduled in 2011 to solve concerns expressed by the industry and regulators regarding MiFID and to take into account evolutions in the market. Some similar topics are currently explored in the US: possible measures required for High Frequency Trading (HFT), flash orders[7], etc...

5. Bespoke OTC derivatives which meet particular counterparty or end-user needs and do not have the level of standardisation nor the liquidity required for central clearing.
6. CESR: Technical advice to the EU Commission – July 2010; Self-initiative report written by K. Swinburne in the process of being reviewed by the EU Parliament – July 2010
7. Advance look given at orders for a fraction of a second to some clients

Four main issues have been highlighted in these proposals:

a. Measures to improve transparency:

Many observers consider that EU markets have become less transparent following the implementation of MiFID, due to the fragmentation of trading venues and the development of platforms subject to pre-trade transparency waivers eg dark pools (off-exchange facilities that allow trading of large blocks of shares with prices posted publicly only after trades are done and which are considered to account for around 6-7% of equity trading). In addition the value of extending post-trade transparency obligations to non-equity instruments in a harmonized way was highlighted during the crisis. **Initial proposals to increase transparency made by some public stakeholders in the perspective of the MiFID review include:**

- Consolidation of post-trade data in a European consolidated tape (such a system has existed in the US for many years), to be set up by the industry with monitoring from ESMA and the Commission

- A review of exceptions to pre-trade transparency (eg large-in-scale thresholds) applying in particular to dark pools

- Clarification of systematic internalizer obligations in terms of data provision

- Improvement of the quality of post-trade information and delays to provide it

- Extension of the scope of the MiFID transparency regime to 'equity-like' instruments (such as ETFs, certificates...) and extension of pre-trade transparency to non-equity instruments traded on organized platforms[8].

- Technical measures to improve transaction reporting under MiFID

b. Alignment of regulations for competing trading venues:

Concerns have been expressed by stock exchanges regarding differences in regulations and supervision between Regulated Markets (RMs) and Multilateral Trading Facilities (MTFs) which potentially advantage MTFs. In addition some platforms such as broker crossing networks (BCNs) are outside MiFID definitions: they are therefore not regulated and their transactions are not disclosed, although some market-driven projects have been initiated[9]. Proposals have therefore been made to harmonize rules applying to similar venues in the EU:

- Alignment of requirements that apply to RMs and MTFs

- Definition of a specific regime for BCNs including notification and reporting obligations and obligations to become MTFs past a certain amount of business

- Some players considering that dark pools may be capturing an increasing amount of trades of fairly low sizes that do not necessarily need to remain confidential have also suggested minimum order sizes for dark pool orders.

c. Measures to monitor high frequency trading (HFT) activities and mitigate potential risks

HFT has grown rapidly over the last years and is considered to represent around 40% of RM and MTF equity trading volumes in the EU and about 60% in the US. Facilitated by market fragmentation, HFT developed in the EU thanks to technological innovation and co-location services provided by stock exchanges (which allow servers to be located as close as possible to an execution venue).

Some players believe co-location raises level playing field issues since it leads to differentiation in market access conditions for investors and intermediaries. The pros and cons of HFT representing such a large proportion of the market are also debated. On one hand HFT advocates believe that it provides liquidity and efficiency leading to lower transaction costs and, being strongly arbitrage related, reduces volatility. On the other hand critics point out the potentially negative impacts of large volumes of HFT on other market stakeholders (eg institutional investors) and possible fragility created by the high proportion of such strategies, particularly when market dislocation arises and swings in share prices may be exacerbated. The alleged role played by HFT traders which are not submitted to market making obligations in precipitating the May 6th flash crash by quitting the market has also been put forward.

Besides proposals to further examine the costs and benefits of HFT, different types of measures have been suggested with regard to HFT and preventing flash crashes in the future: requirements to stress-test trading platforms, regulating firms that pursue HFT strategies, rules to ensure equal access for co-located clients, ruling out of flash orders, review of fee structures in relationship with market-making obligations...

d. Measures to improve investor protection requirements in MiFID

The MiFID review will be the occasion to reassess for example best execution rules following demands that eg investment firms be provided with best execution by the intermediaires with whom they place orders even if they remain categorized as eligible counterparties.

Two additional topics, which have emerged at the occasion of the preliminary discussions around the upcoming MiFID review, should be taken into account:

- Favouring the access of SMEs to capital markets:

    - Following the Small Business Act published by the Commission in 2008, further proposals could be made to facilitate the access of SMEs to capital markets, which is still very limited in the EU. In addition MiFID and the crisis are considered to have further concentrated trade volumes on blue chip stocks.

    - Possible options include adapting listing, prospectus and reporting requirements for SMEs, adapting accounting rules, favouring the emergence of platforms at an EU level with adjusted rules to provide sufficient liquidity to investors interested in SMEs...[10]

    - Improving the functioning of commodities markets and addressing their excessive price volatility:

    - Following orientations of the G20 and actions initiated in the US, the EU Commission is planning to define options for reforming commodities regulations in 2011.

    - Commodities derivatives will be covered by the EMIR directive for transparency and counterparty risk mitigation requirements, but the objective of the Commission is to go further and to address the role played by derivatives and financial markets in the price evolutions of underlying commodities markets as well as the functioning of commodities markets and possible abuse in these markets.

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8. Further evaluation could also be made of the added-value and feasibility of extending post-trade transparency obligations to different non-equity instruments
9. Recently six banks have committed to report the volumes of cash equity trades crossed in their automated crossing systems via a service provided by Markit. The data collected will be published in aggregated form the following afternoon.
10. See for example report published by F. Demarigny on this topic in March 2010

4. On-going initiatives aim at improving the efficiency of post trading infrastructures for exchange traded instruments:

The projects launched several years ago to increase the efficiency of EU post-trading infrastructures will be pursued in parallel. Regulatory intervention may need to be considered in some cases to support on-going market driven processes.

Lifting of the Giovannini barriers:

Work steered by the Commission has been under way since 2001 to remove the 15 barriers to further integration of EU post-trading identified by the Giovannini group. This initiative aimed at facilitating cross-border clearing and settlement covers a variety of topics: technical issues (including rules governing corporate actions, intra-day settlement finality, settlement periods, diversity of IT platforms), legal and fiscal issues (impediments to remote access, restrictions on the location of clearing and settlement, withholding taxes, restrictions on the collection of taxes…). The significant progress made under the leadership of the Cesame and Cesame 2 groups since 2004, that still needs to be finalized, is essential in facilitating the development of further competition and efficiency in the post-trading of cross-border transactions.

The Code of Conduct:

The Code of Conduct, a market driven initiative monitored by the Commission, was implemented in 2006 and has been successful in ensuring greater price transparency, price comparability and unbundling of services in EU clearing and settlement infrastructures. Accounting separation has also reduced possibilities for cross-subsidies across activities. The area which has been the least successful so far is interoperability among EU CCPs which was a major objective pursued by the Code to increase choice and competition among clearing providers in the EU. This is generally explained mainly by the lack of incentive for most competing CCPs to interconnect.

Access and reciprocity principles have been defined as well as risk management and business case criteria and templates in the application measures of the Code, but there is still uncertainty as to whether interoperability can really make sufficient progress without stronger public intervention. Some observers have proposed that legislation would be required to impose non-discriminatory access to trade flows for CCPs and obligations for CCPs to interoperate. The recognition of interoperability in the EMIR legislation may be a first step in this direction.

Implementation of T2S (Target 2 Securities):

T2S, the technical platform developed by the ECB to support borderless securities settlement in the EU is due to be implemented in 2014. It aims at delivering settlement at a low cost and at the same level for cross-border and national settlement and will help to optimize liquidity and collateral management. The implementation of T2S will lead CSDs to outsource their settlement activity to the ECB platform and will introduce competition between CSDs. This should trigger many changes in the settlement and custody sectors: some CSDs are expected to extend the range of services they provide with enhanced asset servicing or issuer services, consolidation is also possible, custodians may also modify their positioning and services accordingly. These evolutions will be facilitated by the lifting of the remaining Giovannini barriers. Some players believe that regulating CSDs and their main functions at EU level should also be considered to support these evolutions.