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Abstract

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1. MARKET STRUCTURE

The supervisory community, both in the US and in the EU has been struck by the fact that considerable volumes of equity trades take place outside the regulated markets. Recently, figures have been put forward in Europe according to which 40% of the turnover in listed shares takes place outside the regulated markets and is executed on other trading venues including OTC.

The purpose of MiFID in this field was undoubtedly to introduce more competition in the trading facilities, and to provide a regulatory environment for Multilateral trading facilities and for Systematic Internalisers. We know, two years after the entry into force of MiFID that the objective was right, and that trading costs have come down significantly. Also, the option of MTF has proved to be valid, as today, they transact a not overwhelming but nevertheless important volume of business.

However some concerns remain.
The first one relates to post- trading information.

I recall § 34 of the MiFID preamble:

Fair competition requires that market participants and investors be able to compare the prices that trading venues (i.e. regulated markets, MTFs and intermediaries) are required to publish. To this end, it is recommended that Member States remove any obstacles which may prevent the consolidation at European level of the relevant information and its publication.

It has not been sufficient to “remove obstacles” to have an adequate system of post trade trading disclosure on an integrated basis. The reliance on the market forces has not been sufficient to create what is usually called a “consolidated tape” for all market venues, with the indication on which venues specific trading is taking place. The development of this tools seems the more essential these days, as trading takes places on such high frequencies this information places a crucial role in the posting of subsequent trades.

Some call for an initiative to deal with the alternative trading techniques such as the crossing networks, and the dark pools. The question is being analysed at CESR, and the figures are being collected and compared to determine what is the dimension of the problem, and to what extent this is different from what happened in the past, before MiFID. Indeed some of the dark trading (i.e. without pre trade transparency of orders/quotes) is based on MiFID waivers, e.g. for block trading at regulated markets/MTF's. But some part is internalised trading within the large banks, who receive orders from their clients, including other banks, but do not expose those to the general trading interest. As to the internal crossing, I'm told that crossing is a service that brokers have offered their clients since always. Do we see today a development that both in nature and in size is different from what existed before and that is likely to disturb our market structure?

In the absence of European figures, on could refer to the US figures relating to NMS shares: 74,6% for displayed trading centres, 24,4% for the undisplayed centres. But differently from Europe, these is not only a consolidated post trade tape, there is also a consolidation quotation system: Why not bundle all lit orders, on exchanges and MTFs, and examine the development of an efficient consolidated quotation system?

Some call attention to the best execution duty, obliging the intermediaries to check where the best price is available. Under the present market structure, so it goes, where parts of the order are not published, best execution cannot be achieved even with smart order routing systems. Best execution is a subject that requires ample supervisory attention, but the way best execution has been defined, however, does not allow easy comparison. The mere difference in dealing with clearing and settlement cost, whether through the central infrastructure or in the books of the banks, makes a significant difference. Therefore best execution does not help us very much. But it could be examined, to make it more reliable, that firms and markets publish statistics about their best execution performance.

But there are several other points of concern in the market structure: sponsored access, high frequency trading and the risks of market disturbance by algorithmic traders going wild, of flash trading creating questions of front running and so on.

All these points will have to be taken up by the European Commission in its ongoing MiFID Review. CESR will provide input to the Commission by Mid 2010. A CESR consultation paper will be published in the spring, outlining CESR's proposed thinking. In the meanwhile, CESR has launched a process whereby proposals for the utilisation of pre-trade transparency waivers are submitted by competent authorities for discussion within CESR. The aim of this process is to ensure a consistent application of the MiFID pre-trade transparency waivers.

2. DERIVATIVES

You will certainly expect me to say also something on the initiatives taken and the proposals released in the fields of the derivatives markets.

The starting point explaining the increasing interest from the regulators for this subject is undoubtedly the financial crisis, and the awareness that substantial systemic risk is present in this part of the market. You remember that in 2008, the Central banks called for urgent action in this field, especially impressed by the sky-high figures of the CSD market, and the threat of the Lehman and AIG cases. In the meantime, we have "benefited" from the Lehman unwinding and know that the nominal figures are not necessarily the full exposure, but still, what remains is very considerable and should be further reduced.

The European Commission has circulated, beginning of this year, a discussion paper on derivatives and market infrastructures, that has been mentioned in the press.

The attention has mainly been focused on the credit default swaps market, but there are other segments of the derivative markets that are several times more important such as the interest rate derivatives, while the equity derivatives represent only a tiny fraction of the overall volume. Here too efficient infrastructure is needed.

Derivatives, esp. CDS all for our attention as a consequence of their high degree of “inter-connectedness”, where defaults in one part of the market might trigger houses of cards in several places. Therefore efforts should be considered to on the one hand reduce the positions, on the other break the circuits, if I may use that market expression.

The former approach consists of portfolio compression, resulting in bilateral or multilateral reduction of positions.

The latter approach has been the work undertaken by the Central Counterparties that can eliminate positions by concentrating them in its books. As a consequence that CCP will have to build in very substantial protections, to be able to withstand the failure of not only one, but in case of need, probably several of its interconnected clients. Collateralisation will be proposed, but there are limits to available collateral. However the solution is not risk free, and CCPs should be subject to stringent capital, risk management, margining and operational standards.

There are several hurdles to make the system work: first is the obligation to clear, which is preconditioned on the contracts being sufficiently standardised. There are basically two methods to incite standardisation, one is by requiring contracts to correspond to regulator criteria, what would be the US approach, the other by imposing stricter capital requirements for non standardised products, what might also be the EU approach. Europe should agree with the American counterpart to ensure that the criteria for standardisation should be largely comparable, or better identical.

But there are several other subjects that deserve attention such as the automation of these market segments and their infrastructures or the position of the end-users of these derivatives.

CESR, or better the future ESMA is planned to play an important rule in the development of technical standards for e.g. standardisation, and for the functioning of the Trade repositories, where it may also be in charge of their supervision.

As you see plenty of work for the industry, the regulators, and the future ESMA.

But I take this occasion to thank you for the excellent cooperation with the industry, in all its parts, and only in an open, continuous and constructive exchange of views can we make progress in devising a better system for Europe, and for its citizens.

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Financial Law Institute

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