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Finance Watch
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Financial Markets: Serving the Real Economy
An 'Investing not Betting' event

Brussels, 10 October 2012

Executive Summary

A Finance Watch event is always about a diverse group of high-level experts confronting their views in a respectful way in order to make the debate progress, stated Finance Watch Secretary General Thierry Philipponnat. Financial markets should serve the simple purpose of making the supply and the demand for capital meet in a fair and transparent manner with a view of serving end investors and corporations. Setting the context for the debate, Philipponnat stated that food shortages make the issue of commodities derivatives topical again and people are asking if we have the right tools to ensure a balance between speculation and hedging that works for society. Referring to high frequency trading (HFT), he said that markets have recently undergone a period of rapid technological evolution without a corresponding leap in regulation. The topic of adverse incentives returns in MiFID with the EU's proposed ban on inducements. Finance Watch will be looking with great interest to see if a recent Parliament vote to drop a proposed ban on inducements will be revisited in the weeks to come.

Nadia Calviño of DG MARKT stated that the two key objectives of the MiFID Review are to increase investor protection and to improve the functioning of EU capital markets. She said MiFID and the Market Abuse Regulation (MAR) could apply from as early as mid-2014. The Commission's policies in favour of investor protection now include a ban of inducements for firms providing independent advice or portfolio management. Financial markets must be fair, transparent, efficient and liquid. She said that a distinctive feature of MiFID's proposed Organised Trading Facility (OTF) versus a Regulated Market (RM) RM or Multilateral Trading Facility (MTF) would be the discretion the operator of the platform could exercise when executing orders. It allows investors willing to hide from HFT traders to choose with what types of order flows they want to interact with and ensures that transparency becomes the general rule except in well-justified cases such as large orders.

MiFID2 Rapporteur Markus Ferber MEP explained that he had to deal with 834 amendments for MiFIR and 1,321 amendments for MiFID, second only to CRD4 in the number of amendments, demonstrating both the importance and complexity of this legislation. The Parliament has now found a good compromise, which says yes to OTFs but is restrictive on various products and how it is used. The idea is to change three things in the current proposal: limiting the OTF category to non-equities, not allowing proprietary trading, and reviewing it in due time. Ferber does not want to remove technology from trading venues, but the question is whether everything which is possible with new technology should be allowed. HFT does provide liquidity, but one has to question the economic benefit of this provided liquidity if most HFT traders want to leave the marketplace in the evening not with shares, but with money. This kind of liquidity can disturb a fair price-building process, and Ferber thinks it is fair for the Parliament to intervene here.

Calviño noted significant concerns about the quality of the liquidity provided by HFT as well as the risks posed in terms of stability and integrity, stating that HFT deserves to be properly regulated in light of the size that it represents in terms of trading and the spill over effect their misbehaviour might have on the integrity and stability of the market as a whole. The Commission's proposals will ensure that every firm that engages in this kind of trading is regulated and supervised and has stringent systems and controls in place in order to prevent abusive behaviour or malfunctioning that could create disorderly market conditions. Naked sponsored access will not be allowed without appropriate pre-trade controls by the investment firm providing this access. HFT traders claim they provide liquidity to the market and are behaving de facto like liquidity providers or market-makers. As they benefit from the market in good times they should also contribute to the market in turbulent times. What everyone wants is to bring financial services and financial markets back to the purpose for which they were created: to fulfil an obligation to the real economy.

The AMF's Thierry Francq stated that technology enables people to do stupid things in clever ways. The organisation of the market is clearly a public good, and at the moment there is a risk of losing investor confidence in financial markets. In his opinion, HFT changes the definition of liquidity. Orders can be sent with no intent to trade, an activity which also changes the functioning of the market, discouraging investors from posting orders or causing them to disappear from the market altogether. There should be consideration of whether this technological arms race is economically sound and efficient. The best tools would be regulation of the fee structure and tick-size regime, as latency – as some suggest – might not be the best way to regulate the market.

FIA EPTA's Remco Lenterman argued that anything to slow down the market would not work. He said technology makes markets more efficient for end-users, and better order book depth and more liquidity make it cheaper to transact, even in large sizes. BATS Chi-X Europe's Mark Hemsley's priority is the creation of a consolidated tape, as also supported by Francq. This is fundamental infrastructure. A pre- and post-trade real-time consolidated tape will provide transparency for all investors and all parts of the financial community, and will aid surveillance. Asset manager and equity trader Ryan Chidley suggested that asset management companies should not be forced to interact with HFT or those claiming to be market-makers. The return on equity for asset managers is not as high as for brokers, HFT or exchanges, and so asset managers cannot compete in this technological arms race.

Themis Trading's Joe Saluzzi asked if narrow spreads are really significant if the quote is not there when you try to hit it. Saluzzi agreed that while HFT can take advantage of the system, the ecosystem of the market has changed. It is now dominated by short-term traders who no longer care what they are trading, at the expense of the long-term investor. The FSA's Tim Rowe argued that when technology is used for front-running or gouging people, it is obviously bad, but when it is used for market-making, it can be good.

Philipponnat intervened from the audience to ask whether the notion of market-making can be applied to HFT. He suggested that market-making is about being slow, about making a bid or an offer for an end investor and sticking with that price. Market-making is slow and risky, and he does not see how this concept can be applied to HFT, which is inherently fast and most offers are withdrawn. Saluzzi said the simple process of buying and selling has become subject to electronic surveillance by other market participants in a process he characterised as a maze of "sweaty handshakes". Simplifying this maze may lose some of the liquidity that HFT brings, but it would also bring back displayed liquidity providers; there would be a lot less volume but a better price discovery process.

Addressing the commodities debate, Ferber stated that in 2008 the EU spent over €100m on food aid programmes, not because there was a bad harvest but because there was such high speculation that people could not afford food. There is a very strong regime developing from what the Commission has proposed – through position limits and the position check system – and this could make a difference in working out which participants have a real interest in the product.
Calviño said there is a growing consensus that financial investors have affected price dynamics over short time horizons.

Over $400bn is traded on commodity markets, explained David Bicchetti; that is over 20 times the physical production. There were huge upswings in the oil price, and even changes to the market in live cattle, following the announcement about the recapitalisation of eurozone banks. This is not an oil (or live cattle) fundamental, so how can this be explained? Maria Teresa Fabregas of the European Commission stated that the Commission understands that while markets are moved by fundamentals, it is not only fundamentals that drive markets. As the markets grow in both the number of participants and in volume, volatility becomes more evident. The Commission has thus introduced several measures, including position reporting by type of trader, and position limits. Frédéric Baule explained that in oil, forward-prices for derivatives do not derive from spot prices but oil prices are derived from the forward-prices of oil traded in the financial sphere.

Mike Masters of Masters Capital Management agreed that commodities are not capital assets; the only value in commodities is in consumption. However, commodities are no longer trading on supply and demand but on the mandate of institutional investors. Speculators are necessary, but what gets lost in the debate is the amount of speculation necessary. He likened this to taking aspirin: take two aspirin and get one effect, take a whole pack of aspirin and you get an entirely different effect. A little speculation is needed, but not so much it drives prices. This is why position limits are required.

Keynote Speech

Thierry Philipponnat, Secretary General, Finance Watch

Thierry Philipponnat welcomed members of the conference, and outlined the aims and objectives of Finance Watch. He said that a Finance Watch event is always about a diverse group of high-level experts confronting their views in a respectful way in order to make the debate progress with a view of contributing in the most constructive possible way to policy making.

Finance Watch has a very fundamental belief when it comes to financial markets: they should serve the simple purpose of making the supply and the demand for capital meet in a fair and transparent manner with a view of serving end investors and corporations. In other words, financial markets, and more generally finance, should be about investing and not betting.

Financial markets have grown unbelievably complex and, looking at all this complexity, one sometimes wonders whether financial markets are still effective at serving their purpose (serving investors and corporations) or only an efficient way for a relatively limited number of players of “playing the market” and benefiting from it.

Philipponnat noted that MiFID is particularly topical. In December 1938, the US Commodity Exchange Commission implemented the first speculative position limits for futures contracts in wheat, corn, oats and other essential foodstuffs. These limits served farmers and consumers well for many decades. Today, food shortages mean this is topical again, and people are asking if we have the right tools to ensure a balance between speculation and hedging that works for society.

In October 1987, the global stock market crash on a day that became known as 'Black Monday'. The Dow Jones Industrial Average lost 22 per cent in a day. At the time, some people blamed it on programme trading, others on excessive speculation. These topics are relevant again today. Then, as now, markets had undergone a period of rapid technological evolution without a corresponding leap in regulation. Then, as now, there were highly profitable financial innovations whose wider consequences were little understood.

In 2007, US authorities created the “Hope Now Alliance” to help homeowners repay their debt. This early response to the sub-prime crisis was needed because the US financial system, layered with adverse incentives and leverage, had gone berserk with miss-selling of mortgages and mortgage-backed securities. The topic returns in MiFID with the EU’s proposed ban on inducements. Finance Watch will be looking with great interest to see if a recent Parliament vote to drop a proposed ban on these adverse incentives will be revisited in the weeks to come.

Concluding, Philipponnat stated that MiFID is a chance to learn from the past and to bring the future of markets back to their core purpose: allocating society’s resources and managing risk.

Keynote Speech

Nadia Calviño, Deputy Director General for Financial Services, Directorate General Internal Market and Services, European Commission

Nadia Calviño explained that the Commission proposals for a review of the Markets in Financial Instruments Directive (MiFID) are currently being considered by the European Parliament and the Council. Critical issues are at stake, from the efficiency and transparency of financial markets, to the protection of investors, and to the international competitiveness of the EU for issuers, investors and investment firms.

The overarching objective of MiFID1 has been to further the integration, competitiveness and efficiency of EU financial markets while at the same time ensuring a high level of investor protection. While these principles remain valid, MiFID1 has revealed some weaknesses and the crisis has clearly demonstrated the need to establish a safer, sounder, more transparent and more responsible financial system working for the economy and the society as a whole.

This is why two key objectives of the review are to increase investor protection and to improve the functioning of EU capital markets.

Calviño stated that the protection of small investors has traditionally been and continues to be at the heart of the Commission's policies. The proposals include a certain number of measures aimed at reinforcing investor protection, notably the ban of inducements for firms providing independent advice or portfolio management.

Equally, EU investors and businesses alike need to be able to rely on efficient and transparent capital markets for investment and financing purposes. Pressure is growing for regulators to ensure that robust and transparent securities markets are prepared to meet the rising demand for capital. Europe needs well-functioning secondary markets whose primary function should be together with primary markets to finance the real economy. Therefore, financial markets must be fair, transparent, efficient and liquid.

Fair means that the best prices should be accessible to all market participants and the latter are protected from abusive behaviour. Transparent means that information on orders and executed transactions should be made publicly available in order to reduce information asymmetries. Efficient means that the price formation process should reflect the fundamental value of the traded instruments and lead to an allocation of capital that best serves the economy, and liquid means that market participants should be able to sell and buy assets within a reasonable time frame in a safe and orderly manner with minimum market impact. Fair, transparent, efficient and liquid markets should go hand in hand with competition on a level playing field between market participants.

How do these objectives translate into the MiFID review?

Market structure

Calviño explained that the introduction of the new Organised Trading Facility (OTF) category aims to ensure that all forms of multilateral trading take place on transparent and regulated trading venues. Similar trading practices should be governed by similar rules and be subject to strict transparency requirements. Trading on an OTF will take place on a level playing field with RMs and MTFs and in a transparent environment. All three would be subject to the same transparency rules and core organisational rules.

The main distinctive feature of an OTF versus a RM or MTF would be the discretion the operator of the platform could exercise when executing orders. This discretion element is needed to have an all-encompassing regulatory framework that would capture all types of existing unregulated multilateral trading venues falling outside the scope of the existing MiFID1 categories. Another example of why this discretion is needed is that it allows investors willing to hide from HFT traders to choose with what types of order flows they want to interact with. This discretion is not absolute: it is limited by pre-trade transparency and by best execution obligations.

In addition the operator of an OTF (and their affiliates) will not be allowed to execute transactions against their own capital on the OTF they operate. This will ensure the neutrality of the firm operating the OTF platform and draw a clear delineation between multilateral and bilateral trading, and would increase the transparency in terms of services offered and costs towards clients and the competition for the benefit of the entire market. Investors would know with whom they are trading and at which cost.

The firm operating the OTF would still be allowed to execute his clients' orders by trading on own account but it would fall under the systematic internaliser (SI) regulatory framework if done on a systematic and frequent basis. The SI regime will draw the line between systematic and ad hoc OTC transactions. The SI regime will become a key feature of the new market structure. This is why the Commission believes that the definition of SI should be strengthened and these players should be subject to strict transparency requirements.

All liquid financial instruments will be subject to strict transparency requirements independently of the platform on which they are traded. The Commission proposals introduce a transparency regime for non-equities markets including derivatives markets. Increased transparency enhances the public good and the integrity of the price discovery mechanism. Transparency should become the general rule except in well-justified cases such as large orders. Increased transparency should reduce information asymmetries, promote competition and ensure a level playing field for end-investors.

These measures, taken together with the trading obligation of standardised OTC derivatives on organised trading venues, will mean that by default only ad hoc and irregular bilateral trading in shares, bonds and non-standardised derivatives will continue to take place OTC outside a fully transparent regulatory framework.

Algorithmic and HFT trading

High frequency trading (HFT), a super-fast sub set of algorithmic trading, has become a predominant form of trading in EU equity financial markets, Calviño said. Significant concerns have been raised about the quality of the liquidity provided as well as the risks posed in terms of stability and integrity for our financial markets by this type of trading. HFT deserves to be properly regulated in light of the size that it represents in terms of trading and the spill over effect their misbehaviour might have on the integrity and stability of the market as a whole.

The Commission's proposals will ensure that every firm that engages in this kind of trading is regulated and supervised and has stringent systems and controls in place in order to prevent abusive behaviour or malfunctioning that could create disorderly market conditions. Naked sponsored access will not be allowed without appropriate pre-trade controls by the investment firm providing this access.

Trading venues will also be required to have proper systems and controls in place to ensure fair and orderly trading conditions and to preserve the integrity of their market. In addition, the conditions for access to trading venues should take place on a fair and non-discriminatory basis. More specifically the conditions under which co-location services are provided as well as the trading fee structures of trading venues have to be fair and non-discriminatory.

Calviño stated that the MIFID proposals together with the review of the Market Abuse Directive (MAD) aim at improving the detection and sanctioning of manipulative practices through HFT. The first step is to ensure regulators have access to the necessary information to monitor trading activity and detect market abuse cases, and this is why the Commission proposes to extend record keeping obligations to orders and to flag the algorithm that is behind the order. The second step is to reinforce the cooperation between competent authorities and facilitate the exchange of information to ensure effective cross-market surveillance. The last step is to strengthen the MAD framework by clearly stipulating which HFT strategies constitute prohibited market manipulation.

One of the most controversial issues in the Commission proposals is the proposed requirement for HFT traders to provide liquidity on a continuous basis. HFT traders claim they provide liquidity to the market and are behaving de facto like liquidity providers or market-makers. As they benefit from the market in good times they should also contribute to the market in turbulent times.

The Commission's objective with this provision is to enhance the quality of the liquidity, the stability and the integrity of our financial markets by:

- requiring genuine high-frequency traders to provide liquidity on a continuous basis rather than providing "ghost" liquidity;
- preventing genuine high-frequency traders to abruptly withdraw from markets causing systemic risk; and
- disciplining the conduct of high-frequency traders and to prevent them from engaging in market manipulative practices.

The Commission wants to better frame this "race to zero", Calviño explained. The costs and externalities caused by this competitive race to speed have become more obvious while the incremental benefits in terms of more efficient price formation mechanism and market liquidity are questionable. Trading volumes should not be equated with liquidity and traffic congestion is a reality. This is why the Commission proposals include measures to slow down the trading process, and the recent self-regulatory initiatives taken by various stock exchanges to alleviate the pressure on their market infrastructure show that this is the right track.

Commodity derivatives

Calviño explained that recent years have seen increases in prices and volatility in all major commodity markets. These increases were accompanied by growing investment inflows into these markets. The combination of these two trends has given rise to a strong debate over whether financialisation can be seen as one of the main drivers of commodity prices over the past years.

There are two related questions to this debate: what is the impact of these financial investments on the functioning of the commodity derivatives markets? And how do these investments in commodity futures markets affect the prices of the spot markets? There is growing consensus that financial investors have affected price dynamics over short time horizons. Additionally, although it is clear that the prices of derivative and physical markets are linked in multiple ways, the nature and extent of these links is still not fully understood.

The Commission has clearly set as a key priority the improvement of the functioning of the derivatives and physical commodity markets. This is why the review of MiFID and MAD include concrete measures to enhance the transparency, integrity and oversight in commodity derivatives markets:

- Introduction of a position reporting by types of traders, based on the useful experience of the US CFTC in this respect;
- Introduction of a position limits regime in order to preserve market integrity and support orderly pricing;
- Mandating trading of standardised OTC derivatives – including commodity derivatives – onto transparent and multilateral trading venues
- Extension of the scope of the MAD review to market abuse cases occurring across both commodity and related derivatives markets.

These measures fully reflect the G20 work and the latest principles of the International Organization of Securities Commissions (IOSCO) which has been working under a mandate from the G20 to improve the regulation of commodity derivatives. Calviño explained that commodity derivatives, like all derivatives, are subject to the G20 roadmap addressing the systemic risks and opacity of OTC derivatives, and commodity derivatives along with all other derivative asset classes are subject to the European regulation on OTC derivatives, central counterparties and trade repositories (EMIR).

The Commission MiFID2 proposals are currently being considered by the European Parliament and the Council. There is a clear political willingness to act swiftly on this file. ECON has voted and the Cyprus Presidency is trying to accelerate work towards an agreement. The Commission will then start working on the implementing measures. Assuming another 18 months is needed to develop these measures, including technical standards, this means that MiFID2 could enter into application as from mid-2014. The timing for entry into force of MAR should be the same.

Keynote Speech

Markus Ferber, Member of the European Parliament and MiFID2 Rapporteur

Markus Ferber opened his remarks by expressing his appreciation for the cooperation of the Parliament over the last few months; the mood was to come to common conclusions and to be strong in negotiations. What everyone wants is to bring financial services and financial markets back to the purpose for which they were created: to fulfil an obligation to the real economy.

Ferber explained that he had to deal with 834 amendments for MiFIR and 1,321 amendments for MiFID, second only to CRD4 in the number of amendments. This demonstrates both the importance and complexity of this legislation.

The question of market structure has been one of the key subjects throughout discussions: is there a need to introduce a new category of trading facility? After a long discussion, the Parliament has decided that such a facility is needed and he thinks that the Parliament has now found a good compromise, which says yes to OTFs but is restrictive on various products and how it is used. For OTFs, there is a degree of discretion over how a transaction should be executed. It is important to avoid loopholes, so the idea is to change three things in the current proposal: limiting the OTF category to non-equities, not allowing proprietary trading, and reviewing it in due time. The Commission is not quite happy with this, but Ferber will see what happens.

Ferber added that for the whole area of OTC derivatives, the Parliament has tried to ensure that if they are traded, they are traded inside the MiFID world; if they are not traded on regulated markets, Parliament wants to bring them inside. Parliament is working with the main rule that for the trading of any financial instrument, the whole market structure is such that whenever a financial failure happens, it happens inside the MiFID world.

HFT is one of those new developments which was not foreseen in MiFID1. Of course Ferber does not want to remove technology from trading venues, but the question is whether everything which is possible with new technology should be allowed. The Commission and Parliament proposals agree that while of course algorithmic trading and HFT are possible, they should be allowed when they create advantages, but should be regulated so that they do not create disadvantages.

On HFT regulation, Ferber suggested that the first thing to be discussed is circuit breakers. The US has introduced a similar system, and Ferber thinks the common approach is a good idea, thus it is one of the key elements in Parliament's legislation. Second, minimum resting periods: at the moment more than 90 per cent of orders placed in HFT are withdrawn before execution, and to avoid this one needs to think on whether minimum resting periods could work or not. Ferber is open to any kind of slowing down, and will welcome any other ideas.

On the MAD and MAR, Ferber stated that the Parliament had to take care with the fact that with HFT there are possibilities to impact the price-building process by placing orders without execution. HFT does provide liquidity, but one has to question the economic benefit of this provided liquidity if most HFT traders want to leave the marketplace in the evening not with shares, but with money. This kind of liquidity can disturb a fair price-building process, and Ferber thinks it is fair for the Parliament to intervene here.

Parliament is also asking for algorithms to be tested to ensure that they are not disturbing the trading venue. The authorities – ESMA and national authorities – should have the right to look inside algorithms, although not to make them public. Additionally, Parliament is considering the fee structure: everything which has a price is a market-driven procedure, and rebates or additional fees can affect the market. Perhaps if one has a higher ratio of orders withdrawn before execution, the rebate should be reduced so that there is less of a problem in the fair price-bidding process.

Moving on to commodities, Ferber explained that while food derivatives markets must function, there cannot be so much volatility disturbing the market in such a way that eventually people in the third world will not have enough to eat. In 2008 the EU spent over €100m on food aid programmes, not because there was a bad harvest but because there was such high speculation that people could not afford food.

Ferber claimed that there is a very strong regime developing from what the Commission has proposed – through position limits and the position check system – and this could make a difference in working out which participants have a real interest in the product. The Parliament is closely following developments in the US, and Ferber thinks this makes sense; at the moment Chicago is the leading market for these products.

Concluding, Ferber stated that what has been achieved so far is good. There are some technical adjustments to be made before MiFID goes to plenary, and then Parliament awaits whatever the Council is doing; he joked that they will be advised to keep as close as possible to the Parliament, so that MiFID can be completed during the Cyprus Presidency.

Europe is keen to set an example for the Asian world, which is very reluctant at the moment to fulfil its G20 commitments and is so far watching what the EU and US are doing. If the EU can provide an example of good and serious regulation, this could be the blueprint for the Asian markets, and this would be a huge advantage for the EU to be a serious partner in the financial sector for the investors of the world. That is what the economy needs.

Q&A with Nadia Calviño and Markus Ferber

Philipponnat asked how the Commission sees the present text, when compared with the original intentions of its proposal.

Calvino explained that the Commission obviously does not agree 100 per cent with everything proposed by the Parliament or the Council, but is not narrow-minded. Throughout the discussion, she is sure that the proposal is being improved, and the Commission is willing to work with both the Parliament and the Council to ensure that the final decisions reflect the basic principles and aims of the proposal.

Asked about how far a supervisory body would supervise both the physical and financial markets combined, Ferber explained that he does not see supervision as a particular problem. Supervision is not being overloaded on either the national or EU-level bodies.

Questioned on the OTF category – in particular, how essential it is, in the light of the recently published Liikanen Report, to maintain the ban on proprietary trading – Ferber was confident that the ban will remain and added that it is certainly the negotiating condition that he will bring to plenary. Calvino added that banning proprietary trading is imperative. There is an inherent conflict of interest in such trading, and she thinks that separation of bilateral and multilateral is a healthy principle.

On the equivalence regime, Ferber was asked whether he sees a conflict approaching between the difference in views between the Council and the Commission/Parliament (which are close in opinion). Ferber agreed that although there is a difference in opinions, the stronger disagreement exists on branch obligations. Equivalence is not his number one priority, but it is also not his last priority. The issue must be solved properly, but this cannot be done in the same way as in the US; Dodd-Frank imposed lots of obligations on national authorities, but that is not how Europe works.

Calvino explained that the Commission is trying to leverage the internal market on third country regimes. The aim is for Europe to have common third country requirements, with a single rule for entry, and passporting. For this reason, equivalency must be determined at the EU-level, not through national regimes.

Addressing the question of inducements, Ferber cautioned that one shouldn't be naïve in thinking that banning inducements will solve all problems. Lots of people won't have access to any financial instruments. Ferber himself was in favour of a subsidiarity approach, as he acknowledges that Member States are very different in their approaches in this area.

Ferber emphasised the need to look at the whole product chain of a financial product, and to give the authorities the powers and rights to intervene. This, with subsidiarity and consumer protection, should get the proposals ahead of MiFID1.

Asked about the dangers of too strict or too soft regulation, Ferber explained that Europe cannot be too strong in comparison to the leading market, Chicago. Paris has a much smaller stand than Chicago, and to strengthen a small stand, one mustn't overload it with regulation. Europe has legislated for a lot of things in the same way that the CFTC is preparing to legislate, and this cooperation between Chicago and Europe should provide a blueprint for the rest of the world to follow. The two markets can come together on strong regulation for the commodity and food markets and Asia will follow, but this cannot be done only at the EU-level.

Calvino added we should also ensure that other activities are properly regulated elsewhere. That is why the Commission has been active in the G20, IOSCO and other supranational bodies. Standards must be exported so as to stop regional bubbles building up. Europe cannot lower its standards to prevent business moving; this is bad in the short-term, medium-term and long-term.

Asked about the definition of liquidity, Ferber suggested that he sees liquidity as a liquid pool. MiFID creates the walls surrounding the pool, allowing liquidity to flow inside without disrupting the environment outside.

It was noted that ECON recently agreed on full transparency for financial advice, and asked what this will mean for independent financial advisers (IFAs), Ferber explained that ECON did not change the Commission's concept, only the name. Non-IFAs will be subject to transparency requirements, and Member States will be allowed to go beyond these minimum requirements.

Ferber added that he misses the question on quality of advice. There needs to be a discussion on how to improve the quality of advice so that advice fits the needs of the client. He does not accept that reducing the whole issue to inducements alone solves anything, it seems too easy, and often the easy solution is not the best. Banning inducements does not imply that quality will improve. Transparency and disclosure rules, along with production intervention powers, may help to improve products, which will then improve the quality of advice.

Philipponnat noted recent AMF research that found that the transparency obligations on inducements in MiFID1 were not respected in 65 per cent of cases.

Questioned over the recent Parliamentary debate on whether it would be okay for companies to deploy their own capital to facilitate a client transaction (in a multilateral trading venue), Ferber stated that market structure was the key issue in discussions between the various political groups. All groups agreed on the basic line – that the structure must ensure that everything takes place within the MiFID world – but debated the details.

On liquidity, specifically whether the debate on liquidity tests should be more forward-looking (how it affects what is inside the liquidity pool) as opposed to focusing on how liquidity affects the outside, Ferber stated that one of the main guiding questions on MiFID and MiFIR is what serves the real economy. All liquidity available should serve the real economy.

Following the suggestion that the EU should follow the US and put position limits on OTC derivatives, Ferber said that he was advised to concentrate on commodities, but has no problem with opening this up if ESMA can be convinced.

Asked about the right balance of detail in MiFID Levels 1 and 2, especially in the need to future-proof the regime, Ferber stated that the Parliament has and will have a strong involvement throughout and has provided guidance on where and how delegated acts and technical standards should be created. Parliament's main rule is that everything political becomes a delegated act, and everything technical becomes a technical standard, but Ferber assured that the Parliament will not be leaving everything to the Commission and ESMA.

Panel Discussion

Commodity derivatives speculation - too much of a good thing?

What explains the recent 30-fold increase in capital inflows to commodity derivatives? What are the consequences for price formation and volatility? How are pension funds and banks treating these markets? What has worked to stabilize prices in the past? Where do we stand with position limits? How can capital best support commodities production and consumption?

Panellists:

- Maria-Teresa Fabregas, Head of Unit, Securities Markets, European Commission
- Judith Hardt, Secretary General, Federation of European Stock Exchanges
- Mike Masters, Founder, Masters Capital Management; and Founder, Better Markets
- David Bicchetti, Division on Globalization and Development Strategies, UNCTAD
- Frédéric Baule, Expert in Products and Derivatives Trading, Risk Management Services, Petroleum industry

Moderator:

- Pauline Skypala, Deputy Markets Editor, Financial Times

Executive Summary

The nature of speculation and its role in commodity derivatives markets was the focus of the first panel session. There was much discussion of the relatively recent growth in commodities markets, and their subsequent financialization. Panellists argued over how much speculation is good in commodities markets, with Mike Masters (Masters Capital Management) explaining that while a little speculation is needed to provide liquidity, there should not be so much speculation that it drives prices. There was also discussion of the Commission's proposals to deal with the problems in commodities markets, including the somewhat controversial proposal to introduce position limits.

Summary

Judith Hardt (FESE) opened the debate by outlining the structure and workings of commodity markets. Commodities are different, she stated, and the most important question to ask is what they are worth.

Commodities were invented in Chicago as a way for farmers to guarantee their crops against the risk of a crisis. Now, commodities are investment opportunities. Ten years ago, commodities markets were backwaters, and since then a lot has happened.

Commodities markets fall into three families: softs (coffee, cocoa, sugar and other agricultural commodities), energy (oil, electricity, natural gas and coal, for example), and metal (for example: aluminium, copper, zinc and lead). All three families are traded on exchanges.

Referring to the 30-fold increase in capital inflows to commodity derivatives, Hardt identified the key question as: why? The reason is because price drives the markets. Soft market price variations are down to the weather and fundamentals, the latter also driving the market in energy. In the metal market, growth in China has had a sustained impact on prices. New investors are increasingly interested in being exposed to the risk of commodity prices.

How to make sure the markets are safe? Hardt explained the need to manage quantity in commodities markets. Unlike other financial markets, commodities are finite, and as there is a finite volume at the end of the contract, there is a need to make sure that there isn't a squeeze. Risk management in commodities is different.

The question is whether an exchange should manage the whole process or whether Europe should impose US-style position limits. Position limits are good – they can combat market manipulation, for example – but even position limits have limits. Position limits cannot stop systemic risk or volatility, and cannot really impact price.

Maria-Teresa Fabregas (European Commission) stated that this area is the focus of a lot of political attention, heightened on a global level since 2009, when the G20 Pittsburgh Summit made clear reference to the need to address excessive commodity price volatility through regulation.

In February 2011, a Commission communication acknowledged that market fundamentals were linked to the strong growth of developing economies. The Commission understands that markets are moved by fundamentals, but that it is not only fundamentals that drive markets. As the markets grow in both the number of participants and in volume, volatility becomes more evident.

The Commission considers transparency crucial to understanding commodities markets: the fundamentals, physical markets and transactions. Any regulation should ensure that these markets remain efficient and provide optimal allocation of risk.

The Commission proposal focuses on key areas to fulfil G20 commitments. The Commission has:

- Adopted pre- and post-trade transparency as a general measure on derivatives.
- Implemented G20 recommendations on mandatory trading of sufficiently liquid and standardised derivatives in organised venues.
- Adopted a European regulation on OTC derivatives, trade repositories and central counterparties.
- Introduced some measures from the US, including position reporting by type of trader.
- Proposed the introduce position limits to support market integrity. Some exemptions will be required, and this is hard to specify.
- Strengthened the powers of the competent authorities, so that the necessary oversight is strengthened.

The Commission has also introduced regulation of professionals providing investment services (MiFID currently includes an exemption for commodities professionals) and has reviewed some of these exemptions, and has broadened the scope of the Market Abuse Directive (MAD) to ensure that sanctions are available for anyone who tries to manipulate the markets through use of financial instruments.

ESMA is already strengthening its knowledge and has created a Commodity Derivatives Task Force**,** and through the introduction and implementation of increased transparency, increased oversight, direct regulation of market participants and mitigation of market abuse, the Commission should be able to ensure that commodities markets serve the real economy.

Asked by moderator Pauline Skypala (Financial Times) if position limits are the most controversial aspect of the Commission's proposals, Fabregas added that the review of exemptions has also proved contentious. On position limits specifically, she noted that while some venues already impose them, they are new to most people. There is additional debate over the level of such limits, and the Council and Parliament are working together on some criteria so as to better frame the debate.

Mike Masters (Masters Capital Management) opened with the suggestion that trading today is very different than in the past. Money influences prices, and without actors acting on fundamentals there is no price formation. How do prices move? The purpose of markets is to allocate price, and markets adjust prices according to supply and demand. This is often forgotten; prices don't move themselves.

Commodities are not capital assets; the only value in commodities is in consumption. There is no value in capital flow. It is therefore odd that people invest in and own commodities for long periods, for portfolio diversification.

Masters explained that commodities markets in the US used to be 20 per cent speculators (this is the example of oil markets in the 1990s, specifically), who were there to provide liquidity and help investors deal with price risk. In 2000, the US changed the rules and opened up a new framework: OTC markets could be used as an alternative to listed exchanges. Now, 70-75 per cent of the market is speculative, and speculation now affects price formation. Commodities are no longer trading on supply and demand but on the mandate of institutional investors.

In 2010, the Dodd-Frank Act introduced further changes. The CFTC passed a regime to impose position limits on both OTC and listed markets. This only works because of the use of listed hedge equivalents for reporting. Without listed hedge equivalents, it would be impossible to compare these markets, but with them market participants are required to report their trades in the same vernacular.

Asked about the comments made by Mitt Romney in which he suggested that he would abolish Dodd-Frank if he were elected, Masters joked that Romney was not going to be elected King. As President, he would have to go through Congress, and it is unlikely that this would happen. Additionally, many institutions are already gearing up for position limits and other derivatives legislation – at great cost – so it appears that the die is cast.

Questioned on the chances of sufficiently strict regulation taking place in the US, Masters explained that Dodd-Frank was controversial when it passed, but is now well progressed in its implementation. The next issue for Dodd-Frank is the courts – and there is an issue for the CFTC, which may go the Supreme Court – but he thinks that despite this the whole body of Dodd-Frank will happen; it has passed the most difficult – legislative – hurdles.

On speculators, and why they are necessary, Masters added that speculators are there to take risk. Hedgers try to transfer risk to somebody else, and this somebody is the speculator. Speculators are necessary, but what gets lost in the debate is the amount of speculation necessary. He likened this to taking aspirin: take two aspirin and get one effect, take a whole pack of aspirin and you get an entirely different effect. A little speculation is needed, but not so much it drives prices. This is why position limits are required. Today markets have too much liquidity and hedgers complain of price volatility.

David Bicchetti (UNCTAD) explained that there is a different kind of speculation on commodities markets, and increasing sophistication has meant a move away from index funds to hedge funds and HFT. Today over $400bn is traded on commodity markets; that is over 20 times the physical production.

The problem is not on the physical market. The root cause is the financialization of commodities markets. Bicchetti gave an example of how a confined oil benchmark (WTI) now closely follows the crisis in Europe. In particular, he noted a huge upswing in the oil price following the announcement about the recapitalisation of eurozone banks. This is not an oil fundamental, so how can this be explained?

The number of commodities transactions exploded in 2005/06 when the exchange went electronic, and a synchronized structural change across commodities started after Lehman Brothers' collapsed. Lehman was a pure financial shock, and in another example, Bicchetti showed how the market in live cattle was also affected.

Although initially a US phenomenon, over the course of 2010 it also became a European problem. Bicchetti suggested that it is impossible for there to consistently and continuously exist positive correlation between commodities and stock exchanges, based only on market fundamentals. Indeed, using more data analysis, Bicchetti showed that in the 2010 flash crash, almost 100 per cent of trades were endogenous (herding), not based on market fundamentals.

In May 2010 when the Brent oil price collapsed, nobody could explain it. Bicchetti stated that it was down to speculation. The financialization of commodities markets means that they no longer respond to fundamentals, they behave like pure financial markets.

Concluding, Bicchetti explained that UNCTAD has some broad recommendations, one being to give the regulator intervention powers similar to those of a central bank when it intervenes in currency markets. The Swiss National Bank (SNB) chose to fix the rate of Swiss francs against the euro because the price given by the market was wrong. The same thing is happening with commodities.

Questioned on what type of regulator this should be, Bicchetti explained that while in the EU, the ECB has a price stability mandate, in other jurisdictions, central banks have wider mandates. Just today, the Governor of the Bank of England suggested that central banks should not focus solely on price stability. Regulators need the kind of power he described, but it could be the central bank.

After much discussion of things that have changed over the last 10 years, Frédéric Baule (Petroleum industry) outlined some things that have not. He said that there is still little chance of understanding oil markets unless you are an oil market professional, or have had privileged access to data for study.

It is also still true that in international markets, oil rarely trades at the fixed price agreed. Buyers and sellers do not agree a price for oil but agree a price formula. 80 per cent of the trades using these price formulae take their reference prices from indices reported daily by a handful of price-reporting agencies.

Baule explained that in oil, there is no such thing as futures contracts or derivatives contracts with derive forward-prices from spot prices. Oil prices are derived from the forward-prices of oil traded in the financial sphere. These prices are translated through various price-reporting agencies, which provide the link and are the bodies in charge of bridging financial oil and physical. There is no oversight here, and this has not changed.

Oil is not a European commodity, and this fact opens up a whole different set of regulatory possibilities and issues that have to be addressed. It makes enforcement a major issue.

So what has changed? There is a growing awareness among regulators of the fragilities if the price indices reported by price-reporting agencies. The Commission has recently issued a consultation on indices and benchmarks, triggered by the LIBOR scandal but extending beyond this into other markets.

Basel III capital requirements create a strong incentive to move from position trading to algorithmic trading. This increases the risk of powerplay between algorithmic traders. Oversight of futures trading is required, and forcing OTC to trade on electronic platforms could have unforeseen circumstances.

What is the way forward? Baule called for an in-depth review of the current situation, to come up with a common line for regulators to approach the commodities market and its difficulties. Baule's one rule for regulators is to improve efficiency. His proposals include defining a proper status for commodities trading houses and banning investors from investing in commodities whose underlying price is based on unrealisable price-reporting agencies, and is not traded on a futures exchange.

Concluding, Baule also suggested extending the HFT regulation from equity markets to commodity markets and wondered why not impose a ban on algorithmic trades linking the commodity and pure financial markets?

Fabregas added, on the indices and benchmarks consultation, that although the LIBOR scandal triggered the consultation, the Commission is going beyond LIBOR. IOSCO has work to do, as any indices that are not transparent in they way they are produced and in the way they work are open to abuse. These indices and benchmarks underpin so many contracts and such a large volume of money, that the Commission and other authorities will have to look very carefully.

When a member of the audience suggested that futures trading is not the only way of forming commodity prices, and that the Commission could encourage commodities markets by means other than futures, Masters agreed, noting that there is limited data on market failures caused by too much speculation. Hardt added that she prefers the term ‘risk-takers’ to ‘speculators’. More liquidity in a market is good; the problems come with abuses and manipulation of price formation. IOSCO is taking baby steps, but is taking steps in the right direction, as there is need for a stronger supervisory system that understands the markets.

Keynote Speech

Thierry Francq, Secretary General, AMF

Thierry Francq said that market structure is a very interesting question. Major and rapid changes in technology in the markets are taking place, and thanks to some major technological breaches, the situation may eventually impact investors’ confidence in the functioning of the market. His remarks focus on the benefits of technology, as well as the risks, and some of the solutions the AMF is undertaking.

The question is not who is in favour of technology and who is against; the point here is that technology is not by itself a means to an end. Technology enables people to do stupid things in clever ways, and the AMF’s job is then to put design into technology: what can technology be used for? Technology can be used by regulators, and they should become more mindful users of it.

There are numerous examples of the benefits of technology for market participants. One that should happen but has not yet is the consolidated tape. This is simple, technologically speaking, but has not yet happened in Europe. Technology could also favour a consolidated quotation system across multiple trading venues.

On the post-trading area, Francq stated that the clearing obligations introduced by EMIR will improve the structure of the market. These new clearing obligations involve counterparty risk at the level of the trading member for a short period of time, but more than before. This is an area where technology can help to lessen the switch. On CRD, Francq thinks that new software and service offerings in the area of collateral management could help people cope with the scarcity of collateral.

To some extent, in many areas in the economy there is no need to regulate technology. In a perfect and efficient market, technology is naturally used for good, at least in principle. However, this is a different situation. The organisation of the market is clearly a public good, and because of the risk of dysfunction to the market, and because this is a key element of the allocation of capital in the economy, markets are regulated.

Focusing on the impact of technology on the microstructure of the markets, Francq stated that technology has substantial effects. Large-scale users of trading horizons may create endogeneity in financial markets. This is not new, but can be exacerbated. Francq also warned of the dangers of facing a new kind of liquidity crisis, or at least an extraordinarily rapid liquidity crash. It is something that has happened in the past, but this would be much more rapid.

More than that, Francq suggested that there is a risk of losing investor confidence in financial markets. Francq stated that two areas where the use and impact of technology should be assessed are HFT and best execution.

HFT is a well-known issue now and in his view, HFT changes the definition of liquidity. This means that the usual tools used to measure liquidity can no longer be used. Another issue is that orders can be sent with no intent to trade, an activity which also changes the functioning of the market, discouraging investors from posting orders or causing them to disappear from the market altogether.

Technology can also generate illiquidity in the market. It has always been the case that there is competition – some brokers with better investments and better capabilities will have the advantage vis-à-vis their competitors – but today there should be consideration of whether this technological arms race is economically sound and efficient.

The last issue is the potential for using HFT for market abuse. It is a clear problem for regulators and clearly regulators need better access to data to better assess the functioning of the markets. Regulators need access to more data than the global regulatory community asks for today.

Moving on to best execution, Francq warned that if care is not taken, technology is a vector to simplify the concept of better execution, which will produce a situation that creates new monopolies. Not the old monopolies of trading venues, but new monopolies of those with access to better technology.

Another factor insufficiently taken into account is cost. Technology has a cost, and Francq suggested asking the question: is the cost of this technological arms race economically beneficial for the community? This consideration should encompass all costs: investment in IT for traders, upgrading the market infrastructure to support the increased volume, creating a new system to strengthen the operational risk and also the cost for supervisors, taking into account that supervisors are usually paid by market participants.

Concluding, Francq stated that we should not be against technology; technology can help the regulator and the regulatory framework to cope with new challenges. However, there are several important aspects that need to be changed: the regulator should have a possible say in the fee structure of trading venues – one element to work on is the question of whether fees should be imposed on the overall trade or some parts. A way to limit the possible negative impact of HFT could be to introduce a new tick-size regime. The AMF has noticed that the tick-size regime has a great impact on the functioning of the markets and the position of HFT.

We need to take into account two competing dynamics: one is regulatory and one is the evolution of technology in the markets. Francq considers the regulators legitimate in looking at the impact of technology, maybe to avoid slippage, but also to use it to better regulate the market. The issue is not so much technology, but in the recognition that the organisation of the markets and the risk in the structure of the market should be in the interests of the community.

Q&A with Thierry Francq

When it was suggested that the big issue for the AMF is not a principles-based debate, but enforcement and sanctions, Francq stated that while his focus in not on market abuse, its impact on the microstructure of the markets is high and so it should be looked at, not only for moral reasons, but for economic ones. If supervisors are able to detect market abuse using high technology, they need to be equipped with this technology. This has a cost, and the cost of technology must be weighed against the advantages that technology brings.

Asked how many staff supervisors would need if they were to have access to the order book, Francq explained that it has been a long time since it was still possible to survey the market without computers. In much the same way as the industry, supervisors invest in IT and develop algorithms to detect market abuse.

If supervisors want to detect market manipulation, they will need access to the order book and to multiple trading venues. This will create a huge amount of data that will need to be analysed at the microsecond level, and this could be impossible. However, it once again boils down to an economic question: do the advantages gained through the costly investment in technology for an almost perfect system outweigh the advantages that HFT brings?

Questioned on Parliament's contemplation of a minimum waiting period requirement, Francq suggested that the best tools would instead be regulation of the fee structure and tick-size regime. Latency might not be the best way to regulate the market.

Today, the discussion is of MiFID, but changing a law takes 5 years, and in the world of technological evolution, 5 years is infinite. Francq does not want to see technically detailed solutions put into law, but instead wants regulators to be given a toolbox with which to address the problem. He wants to see in MiFID the tools for regulators to make some intervention on latency, for example, but they should not have to use all the tools. The most efficient solution could be different from market to market and the perfect solution could change rapidly.

Panel Discussion

Market structure and technology – who benefits?

What are the lessons from MiFID1 and Reg NMS? Has fragmentation and the technological 'arms race' benefited end-users or intermediaries? What tools do regulators need to tackle predatory HFT strategies and keep markets stable? Will MiFID2 improve investor and issuer confidence in markets? What obligations and incentives should market-makers have?

Panellists:

- Mark Hemsley, CEO, BATS Chi-X Europe
- Joe Saluzzi, Co-founder and Co-head of Equity Trading, Themis Trading LLC
- Ryan Chidley, Senior Equity Trader, APG Asset Management
- Tim Rowe, Manager of Trading Platforms and Settlement Policy, FSA
- Remco Lenterman, Chairman, FIA-EPTA

Moderator:

- Benoît Lallemand, Senior Research Analyst, Finance Watch

Executive Summary

Discussion during the second panel session focused on market structure and the impact of technology on the functioning of markets. The benefits and disadvantages of HFT were closely debated, with panellists both for and against proposals to slow the market down. It was widely agreed that there is no way to step back from technology – computers cannot be removed from the markets – but several panellists suggested that there may come a point when the advantages of technology no longer outweigh the negative effects. There was some discussion of the future uses of technology, including in regulation and surveillance, as well as in the creation of a consolidated tape. Tim Rowe (FSA) concluded the discussion with the notion that technology is not a problem by itself; bad behaviour is what needs to be looked at.

Summary

Opening the debate, Remco Lenterman (FIA-EPTA) stated that market participants do not benefit from technology. Technology makes markets more efficient for end-users (pension funds and retail consumers) and therefore less beneficial for intermediaries.

For institutional commissions, 60-80 per cent of execution-only business is done through algorithms with a spread of 1-3 basis points; this brings huge savings for end users. Along with commission, end-users also pay transaction costs (or execution shortfall), costs which have also declined significantly in both the US and Europe since 2003. Markets have never been better for end-users: they are cheap and liquid.

High frequency traders recognise that there are sceptics, but Lenterman claimed that HFT also brings a lot to investors. He noted that some large institutions – including Blackrock and Vanguard, for example – think that large HFT has benefited them as their ability to trade stock for clients has improved. Some asset managers do think differently, but Lenterman stressed that there is not a general view.

Lenterman defined liquidity as a measure of the cost of transferring an asset into cash. Liquidity is not the same as volume; liquidity is to do with the depth of the order book. Technology has improved this and in some cases, liquidity has improved three times over (as in the examples of Deutsche Börse, the FTSE and the CAC). Better order book depth and more liquidity make it cheaper to transact, even in large sizes.

Lenterman suggested that any attempt to slow markets down – by imposing a minimum order resting time, for example – would move things in the opposite direction, and would decrease liquidity. HFT participants exist to provide liquidity in times of high volatility, and there is lots of data to back this up.

Addressing MiFID, Lenterman stated that he believes in safe markets. There have been big errors and technology-related mistakes – as in the India flash crash – so the focus must be on safety. He supports resilient and safe markets, with regulation of all direct market participants (members of exchanges) and the promotion of risk management. He is sceptical of anything that would slow markets down or increase costs for end-users, as this would harm liquidity.

Questioned on his definition of liquidity, Lenterman explained that the 2008 crisis was caused by products with zero liquidity, and no liquidity in the market caused the collapse of the entire financial system. Liquidity is very important because it makes it cheaper to transact, ensuring that you can always buy or sell, even in times of stress.

Equity trader Ryan Chidley (APG Asset Management) stated that the 2008/09 crisis had many implications, one of which was that the return on equity decreased dramatically. This has led to an increase in the number of measurements of the cost of trading.

The costs of trading can be split into three areas: explicit (commission and taxes), slippage, and execution (the primary costs of trading, including volatility, which is a function of the macroeconomic environment). Chidley defines slippage as when somebody detects your order before you complete it, and in his opinion HFT has inherited this behaviour.

Chidley liked the development of broker-crossing systems, and his concern with MiFID2 is the pressure it will create to recentralise liquidity. His business has been more harmed in the past by exchanges than by HFT or brokers.

Chidley was a fan of OTFs, but as this has been taken off the table, MTFs should be sufficiently designed to allow asset managers to customise their counterparties (so that companies like APG Asset Management can deal with parties similar to themselves). Asset management companies should not be forced to interact with HFT or those claiming to be market-makers.

It was suggested by a member of the audience that corporate issuers should also have more say over how their equity is traded, and over who holds their stock. Chidley agreed that he has for some time been suspicious of the seemingly incestuous relationship between political institutions and the centralised source of liquidity.

Mark Hemsley (BATS Chi-X Europe) added that corporates want to know where their stock is traded and who is holding it. This information is difficult to track, particularly in a fragmented post-trade environment. It is difficult and expensive to track stocks through the post-trade structure.

Questioned on how much of the front-running problem is emphasised by the policy of exchanges and how much by the lack of technology investment by asset managers and traders, Chidley stated that asset managers can only invest to a certain extent. The return on equity for asset managers is not as high as for brokers, HFT or exchanges, and so asset managers cannot compete in a technological arms race.

Hemsley added that brokers do have some advantage. The recent dramatic reduction in response times on exchanges is slowing down, and the ability to win simply by being fast has also diminished. Brokers have got smarter about providing tools for a fragmented environment, and whilst fund managers can't or won't invest, brokers are, and are offering better execution solutions as a result.

Lenterman also added that while expenses have clearly gone up for intermediaries, including asset managers, the benefits have been accrued for clients. Technology has not been a positive development for asset managers.

Asked if he is in favour of a disconnected market, where asset managers are insulated from front-running and other activities taking place in the open market, Chidley explained that there is a distinction between wholesale markets and markets where everyone can see what you are doing. The top fifty asset management companies worldwide are trading order sizes sometimes up to 20-30 per cent the size of the exchange, and a trade this large can't be negotiated with everyone watching.

Hemsley warned that selection of counterparties is not permitted at the moment because MiFID requires non-discrimination; selection of counterparties was a feature of OTFs and broker-crossing networks. He also noted that in Europe, past attempts to create co-lingual environments with only institutional players have not been successful, as they have not been able to attract enough liquidity.

Describing his business, Hemsley stated that the Single Market is fundamental to how he operates. His vision is to create a highly efficient, highly transparent, fair and liquid, pan-European market in BATS Chi-X. This is distinct from its competitors, which are largely regional in their focus. BATS Chi-X allows investors to invest in all listed corporates from a single connection, the idea being to offer a pan-European capital market which connects all investors, and which can then be opened to the US and Asia, where investors often find the European market too complex.

BATS Chi-X has made a lot of changes to the current procedures, including creating a single set of tick-size tables. Hemsley is convinced that a single European market requires a single approach. Other areas where BATS Chi-X has led the charge include creating a standardised symbology (allowing consistent identification of securities across Europe). This has been put in trust and is free to use and open to everyone.

Additionally, BATS Chi-X has introduced interoperability. Any customer of the exchange can choose one of four clearing houses. Customer choice improves the operational infrastructure and creates a more efficient capital structure. Additionally, if the exchange loses one or even two clearing houses it can carry on trading. Hemsley wants to enable consolidation in Europe, with a single European capital market supporting 4-5 pan-European clearing houses.

Hemsley also claimed that BATS Chi-X has the highest quality surveillance in Europe. It implements pattern recognition techniques across the market, and is able to identify specific individuals and stop them trading on other markets as well as its own. BATS Chi-X is facilitating cross-market surveillance and is also about to release a series of risk management controls that will be made available to market participants and will enable them to control access to the exchange remotely.

Hemsley's priority is the creation of a consolidated tape. This is fundamental infrastructure. A pre- and post-trade real-time consolidated tape will provide transparency for all investors and all parts of the financial community, and will aid surveillance. This tape must be made available free to corporate treasurers so that they can see where their stock is traded.

So why hasn't a consolidated tape been created? Arguments include that there are problems with standards and that because OTC trades aren't included it won't be useful. Hemsley claimed that both of these arguments are rubbish, as both issues can be dealt with. OTC reporting got away in MiFID1, but hopefully the A2A reporting regime in MiFID2 will improve things. Concluding, Hemsley stated that the main reason a consolidated tape won't happen is because the top revenue line for incumbent exchanges is made from market data. Unless a way can be found of allowing exchanges to make some money from the consolidated tape, it is unlikely to happen.

Challenged as to whether BATS Chi-X has any plans to consolidate its two pools of liquidity, Hemsley reiterated his support for a single European market and explained that BATS Chi-X runs two liquidity books because that is what customers demand. The exchange is about to introduce new order types that will allow both books to be linked together for those customers who would prefer that option.

Joe Saluzzi (Themis Trading LLC) opened his presentation with a diagram of the US stock market. Questioning why it looks so complex, Saluzzi ran through a short history of the market and the role of regulation in increasing this complexity. The lesson is that massive regulation can lead to massive unintended consequences.

Outlining the current problems, Saluzzi stated that the rebate model distorts market flow, that certain order types give advantages and that proprietary data feeds skew the market because not everyone buys them. For example, the Securities Information Processor (SIP) in the US is slower than individual feeds, and as most dark pools price off the SIP their quotes become stale quickly and this creates latency arbitrage.

In the US, the SEC is supposed to be watching this. However, the SEC has failed on its core mandate to protect the long-term investor, and is now tinkering round the edges. This has taken away the responsibilities of a traditional market-maker – although market participants may have disagreed with specialists, they did at least have an obligation.

On spreads, Saluzzi questioned whether the reduction in spreads is enough to compensate the rising costs for regulators, investors and anyone else involved in the technological arms race. He posed the question: do spreads even matter anymore, suggesting that spreads are now a meaningless notion because quotes don't exist.

An audience member made the suggestion that because of the full cost of execution, it actually costs more to trade now, even if the spreads are lower. Saluzzi agreed, adding that the cost of a trade goes through several price levels. Lots of institutions don't have time to tinker with their stocks, and by the time trades have gone through all the algorithms required to deal with conflicts of interest, they look very ugly. The cost is not in the algorithm, but in the execution.

Challenged by Lenterman on his data, Saluzzi explained further that if implementation costs are the same and spreads have gone down, yet trading costs remain flat, something has happened to the benefit cost. Hemsley added that there are differences between the US and EU: tick-sizes are not fixed in the EU, but are in the US, and commissions are basis point-based in the EU but fixed in stock in the US. Comparison is difficult.

Saluzzi accepted that tick-sizes are an issue, and he would encourage widening tick-sizes. The SEC is deciding on this issue and he thinks that a pilot programme would be a great idea. Hemsley agreed that is should be proportionate to activity, and Saluzzi clarified that the issuer should also have a say in the tick.

Lenterman intervened to suggest that while HFT has been an enabler of fragmentation, it is not the cause. Saluzzi agreed while that HFT can take advantage of the system, the ecosystem of the market has changed. It is now dominated by short-term traders who no longer care what they are trading, at the expense of the long-term investor.

Moving the debate away from structure and back to technology, Tim Rowe (FSA) stated that technology is an expensive and expansive concept. It is not the case that technology and HFT are the same thing, nor that technology automatically implies a technological arms race. Technology can be used for speed, but it can also be used for surveillance, control, or slowing things down.

So who benefits from technology? Rowe suggested that this depends on what kind of technology is being discussed. The proposals in MiFID2 on technology – including a maximum order to trade ratio, a minimum resting time and changes to the fee structure – are solutions, but nobody has yet defined the problem. Until the problem is identified, it will be hard to find a way forward.

HFT is both good and bad. It has tightened spreads and created more depth in order books, both of which are good things. However, it has also created market asymmetries and differences across asset classes and instruments. The role of HFT differs depending on market condition; it is probably beneficial when markets are sanguine, but not so much when markets are stressed.

Rowe remarked that HFT is not a trading strategy in itself; it simply allows old trading strategies to be done at new speeds. When it is used for front-running or gouging people, it is obviously bad, but when it is used for market-making, it is good. Whether HFT is good or bad thus depends on the faculty being looked at.

There is a need for research, and Rowe conceded that there is a huge amount being done. Research should look at the costs and social costs and consider at what point it might be possible for technology to go too far. Pushed on this by moderator Benoît Lallemand (Finance Watch), Rowe added that there comes a balance point where more data or information is needed. Technology does not imply evil intent, but evil intent by itself is sufficient that regulators need high-quality technology.

Asked about the impact of a financial tax on modifications and cancellations of orders, Lenterman suggested that such a tax would force many exchange-traded derivatives to become OTC only. There would be much less competition between exchanges; new exchanges have much higher order to trade ratios than incumbent exchanges, so entry to the market would be much harder.

Hemsley added that in his opinion such a tax would be a clumsy implementation of an attractive idea. Order to trade ratios do need management, but this should be done through discussions with regulators, and not by a one-size-fits-all fine. Saluzzi remarked upon the bandwidth issue, suggesting that – like mobile phone or internet bandwidth – you get charged more for using more bandwidth. He thinks that a cancellation fee would be better than a flat transaction tax, as the latter also discourages investment.

Philipponnat intervened from the audience to ask whether the notion of market-making can be applied to HFT. He suggested that market-making is about being slow, about making a bid for an end investor and sticking with that price. Market-making is slow and risky, and he does not see how this concept can be applied to HFT, which is inherently fast.

Lenterman explained how HFT deals with trading, explaining that speed has a huge positive impact and huge benefits for the end user. The only way to guarantee one cent spreads is through speed. There is no way for a market-maker in an exchange-traded market to withdraw a quote before it has been traded – transaction is the first knowledge. Saluzzi argued that there is a way – he noted a recent fine in the US for that very action – and Chidley added that the real problem is that the moment a trader gets hit on one trade, they cancel them all, but Lenterman insisted that this is a problem with market structure and latency between exchanges, not with HFT itself.

Asked whether he would advocate banning HFT outright until proper pre-trade surveillance and access to a consolidated order book is granted, Rowe argued that it is wrong to focus only on the concerns while ignoring the benefits. You don't necessarily ban something that might be doing good, and Saluzzi agreed, adding that he would not ban HFT, but would fix the structure.

One final question focused on whether the panellists would choose to regulate more on a global level or create niches, Lenterman said that he would prefer ESMA to come up with more tailored regulation. Saluzzi said that it is clear that the simple process of buying and selling has become a maze of "sweaty handshakes". Simplifying this maze may lose some of the liquidity that HFT brings, but it would also bring back displayed liquidity providers; there would be a lot less volume but a better price discovery process.

Rowe concluded by stating that his concern is not about technology but behaviour. The problem with deleting an order is not the speed of deletion, but the *reason* for deletion. Technology and HFT is not a problem by itself, bad behaviour is the thing that should be looked at.

Keynote Speech

Laurent Degabriel, Head of Division, Investment and Reporting, ESMA

Laurent Degabriel focused his remarks on two areas: ESMA, what it is and what it is doing, and investors and investor protection. The first half of his speech outlined ESMA as on organisation, noting its mission statement, its role in informing the competency of supervision across markets, and its core values, including independence (from the financial industry, but also from the Commission) and cooperation (ESMA works in close contact with those groups and with other relevant stakeholders).

Degabriel stated that investor protection is central to ESMA. It is not a single domain but a number of axes, all related to each other and all impacting directly or indirectly on investor protection. The three key areas for ESMA are: investor education, financial innovation and product intervention.

Investor education

Degabriel noted that there are a lot of good initiatives taking place in Europe and beyond on financial education – the OECD has done a very good mapping of initiatives here, and is continuing its work on that. The level of expertise across Europe is generally good but varied, so ESMA wants to work on the existing initiatives, while also developing best practices and bringing all countries to the same level. ESMA will also be rolling out some specifications, and is planning an upcoming series of publications, entitled 'Knowing your rights' for investors.

Financial innovation

Financial innovation is really core for ESMA. ESMA is undertaking a number of initiatives jointly with EIOPA and the EBA in this area. It is a difficult area because retail customers are different across Europe – there is no such thing as an average European retail investor – and the level of financial innovation is huge and very diverse. The question is how to keep the good parts of innovation without being stuck with the bad.

ESMA plans to leverage the existing initiatives, establishing a monitoring capacity of innovation across Europe. ESMA wants to be able to see what's going on in all countries and wants to increase activity: "it is good to solve the last crisis but even better to be prepared for the next crisis". Last, ESMA wants to be prepared for possible product intervention and will try to come up with appropriate tools.

Product intervention

Degabriel explained that ESMA has undertaken a survey and found that the powers of national authorities across Europe are pretty diversified but are also pretty high. There is increasing recognition at the national level about the possibility of widening core investor protection through powers to intervene earlier, possibly at the distribution phase, depending on product design.

ESMA has seen diverse national initiatives in this sphere, and several countries have come up with different things. For the time being, the powers of ESMA are pretty limited in this area and are mainly restricted only to emergencies. ESMA is trying to be active here though, and has already issued two investor warnings. It will be important not to overuse the product intervention tool. Lot of things can be done that go beyond banning products and services, including rules on disclosure, transparency and product information, which can sometimes be more useful than outright bans.

On investor protection itself, specifically on the rules that are directly for protecting investors, ESMA has issued two sets of guidelines – one on suitability, in order to improve due diligence on information available for clients, and on activity requirements for financial institutions, and the second on compliance and the compliance function. The upcoming one is guidelines about remuneration; ESMA wants to force the need for policies to be compliant with all the regulations in MiFID1, particularly those around conflicts of interest.

ESMA is aware of MiFID2 and has a lot to do. As soon as the text is approved, ESMA will be ready to start the ball rolling. What is really important in MiFID2 is that the right text comes out. Earlier Degabriel mentioned that product intervention is important, but he thinks there are better, more efficient tools available.

Disclosure of information is absolutely needed, but disclosure by itself is not enough. For example, banning inducements is not enough; in some cases, the nature of advice is so important that it can justify banning, but the fee model in place in a number of countries is impacting on the quality of advice given to investors. Banning inducements in some cases – portfolio management and independent advice – has consequences that require consideration. However, overall ESMA thinks that this is a good thing and should come to fruition.

Concluding, Degabriel stated that ESMA has clear priorities and processes. ESMA has been delivering efficiently and is committed to investor protection. However, it is important that the level 1 texts, on which ESMA has no say, are the right ones.

Q&A with Laurent Degabriel

Asked about his support for a ban on inducements for financial advisers, Degabriel explained that he supports the ban for portfolio management and independent financial advice. ESMA has not been solicited for its opinion on any other inducement bans, so his official position is limited to just these areas.

Questioned on the processes and composition of ESMA working groups, Degabriel stated that the groups will comprise a wide representation of stakeholders. The processes for composing the groups are very transparent, but the difficulties are always the same: some stakeholder groups are harder to get than others (for example, retail investors). ESMA is making good progress.

Degabriel also stated that in his personal view, the legal game is already very complex and so ESMA should not necessarily play a role in determining level 1 legislation. ESMA should not be a political force. This is not ESMA's mandate and the organisation is already very busy. However, ESMA has technical expertise and is close to the fact, so it is always willing to provide advice.