Nadia Calviño

Finance watch

10 October 2012

THE MIFID REVIEW

Ladies and gentlemen,

I am delighted to have been given the opportunity to address you all at this Finance Watch event.

The Commission proposals for a review of the Markets in Financial Instruments Directive (MiFID) – commonly known as MiFID II - are currently being considered by the European Parliament and the Council. Critical issues are at stake, from the efficiency and transparency of our 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 MiFID I 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 MiFID I 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 this review are to increase investor protection and to improve the functioning of EU capital markets.

With regard to the first objective, the protection of small investors has traditionally been and continues to be at the heart of the Commission's policies. This is why our 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.

With respect to the second objective, in these turbulent times, and with banks having to go through a delicate deleveraging exercise, 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 we need financial markets that are fair, transparent, efficient and liquid – But what does it mean concretely?

Fair: the best prices should be accessible to all market participants and the latter are protected from abusive behaviour

Transparent: information on orders and executed transactions should be made publicly available in order to reduce information asymmetries

Efficient: 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

Liquid: 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

Bearing in mind that 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?

In the time I have I will try to explain how these objectives translate into the MiFID review with regard to the topics that will be discussed in the subsequent panels i.e. the market structure, high frequency trading and commodity derivatives markets .

1. Market structure

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 MiFID I categories. This would ensure that for example voice broking systems are caught, although they will have to apply identical pre-trade transparency requirements. 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. It should be stressed that 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. This would also 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. Investors would still be able to rely on different execution methods but this would be made completely transparent to them. 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 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.

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

The above mentioned 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.

2. Algorithmic and HFT trading

Of course we welcome technological developments. Innovations such as algorithmic trading have both facilitated the competition brought by MiFID I and helped investors deal with a fragmented and more complex trading environment.

However today high frequency trading, a super-fast sub set of algorithmic trading, has become a predominant form of trading in EU equity financial markets. 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. These concerns have to a certain extent driven institutional investors to trade in the dark trying to hide from HFT trading and undermine the confidence in our financial markets.

Recent several malfunctioning examples have also highlighted that these technological innovations are not without risk. The analysis of the May 6, 2010 flash crash underlined the fact that even if HFT trading firms may not have been the cause of this crash, the way and speed of their reaction had greatly amplified its effects. More recently Knight Capital, one of the most experienced HFT firms, went bankrupt within an hour after having caused severe market disruptions because of a rogue algorithm.

Clearly 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.

First, 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.

Second, the MIFID proposals together with the review of the Market Abuse Directive (MAD) aim at improving the detection and sanctioning of manipulative practices through high frequency trading. The first step is to ensure regulators have access to the necessary information to monitor trading activity and detect market abuse cases. This is why we propose 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 Market Abuse Directive (MAD) framework by clearly stipulating which HFT strategies constitute prohibited market manipulation.

Third, one of the most controversial issues in the Commission proposals i.e. 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. Our 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.

Finally, we want to better frame this "race to zero". The incremental costs and externalities caused by this competitive race to speed have become more and more obvious while the incremental benefits in terms of more efficient price formation mechanism and market liquidity are questionable. As demonstrated by the flash crash 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 i.e. the introduction of an order to executed ratio and a minimum tick size. I would say that the recent self-regulatory initiatives taken by various stock exchanges to alleviate the pressure on their market infrastructure show that we are on the right track. Other ideas debated among politicians and experts are the introduction of a minimum resting time for orders and the regulation of trading fees.

Commodity derivatives

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. First what is the impact of these financial investments on the functioning of the commodity derivatives markets? And second how do these investments in commodity futures markets affect the prices of the spot markets? With regard to the first question there is growing consensus that financial investors have affected price dynamics over short time horizons. The second question is subject to an on-going debate. Although it is clear that the prices of derivative and physical markets are linked in multiple ways, we still do not fully understand the nature and extent of these links.

These concerns have led to increased calls for policy responses to ensure these derivatives keep serving their initial purpose of price discovery and hedging for the benefit of consumers and producers. The Commission has been actively engaged in this debate since many years and 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 Commodity Futures Trading Commission (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
- Finally these measures will be complemented by the Market Abuse Directive (MAD) review which among others extends its scope to market abuse cases occurring across both commodity and related derivatives markets. Using derivatives to manipulate the price of the related spot markets or using transactions in the spot markets to manipulate derivatives markets will be clearly prohibited.

These measures fully reflect the G20 work and the latest principles of the International Organisations of Securities Commissions (IOSCO) which has been working under a mandate from the G20 to improve the regulation of commodity derivatives.

Let me remind you as well that commodity derivatives, like all derivatives, are subject to the G20 roadmap addressing the systemic risks and opacity of OTC derivatives. Commodity derivatives along with all other derivative asset classes are subject to the European regulation on OTC derivatives, central counterparties and trade repositories (commonly known under the acronym EMIR) entered into force on 16th of August and requiring standardised derivatives to be centrally cleared and all derivatives to be reported to trade repositories

Finally let me give you a brief update on the negotiation process and the expected timing. The Commission MiFID II proposals are currently being considered by the European Parliament and the Council. There is a clear political willingness to act swiftly on this file. The European Parliament has voted in the Economic and Monetary Affairs committee on the 26th of September. Concerning the Council, the Cyprus PRES is trying to accelerate work. Therefore a political agreement could be reached during the Cyprus Presidency. 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 MiFID II could enter into application as from mid-2014. The timing for entry into force of MAR should be the same in view of the interconnectedness of these two pieces of legislation.

The European Commission as facilitator in the trilogues will ensure that the right balance is found to establish efficient and effective markets in Europe that help to restore market confidence and that serve the real economy.

Thank you for your attention.