

GOVERNMENT RESPONSE

HOUSE OF LORDS EUROPEAN UNION COMMITTEE REPORT:

MIFID II: Getting it right for the City and EU financial Services Industry (published 10 July 2012)

The Government welcomes the European Union Committee's report on the European Commission proposals to replace the existing Markets in Financial Instruments Directive ("MiFID")¹ with a Regulation and a Directive ("MiFID II").

MiFID, applied in the EU since November 2007, is a key pillar of the EU Financial Services Action Plan. Its main objectives are to improve the competitiveness of EU financial markets by creating a genuine single market for investment services and activities, and to ensure a harmonised, high degree of protection for investors in financial instruments, such as shares, bonds, derivatives, and various structured products.

The Government fully agrees with the Committee that, given the size and complexity of MiFID, it is important to ensure the legislation is fit for purpose before MiFID II comes into force; and also that as much clarity as possible should be set out in the Level 1 framework text. As discussion and negotiation on the proposals has progressed, the Government has engaged with its Member State partners, the European Commission, the European Parliament, and other stakeholders to seek to achieve this.

MiFID is fundamentally important to the operation of financial markets, and through them has a significant impact on the wider economy. Greater competition among infrastructure providers, a central goal of MiFID, is generally recognised as having driven down trading charges and stimulated innovation. To ensure the review proposals for MiFID II build on the successes of MiFID, the Government believes they must strengthen the single market, encourage the global competitiveness of European markets, and continue to underpin sound and efficient markets.

There is much to welcome in the proposals. However, as the Committee has identified, there are areas of concern where the proposals could damage

¹ Directive 2004/39/EC

competitiveness, choice, or efficient markets. The Government believes that measures to improve investor protection could also be strengthened. The following sections address the specific conclusions (set out in bold text below) of the Committee's report.

Organised Trading Facilities (OTFs) and the over-the-counter (OTC) market

We acknowledge the Commission's rationale in proposing the introduction of a new category of Organised Trading Facility (OTF) in order to bring trading on to more organised electronic venues. We also acknowledge the evidence that has been put to us that the over-the-counter (OTC) market has developed in ways that were not initially foreseen. However, we are concerned about the difficulties that would result from a ban on 'own capital', as well as the amount of detail about the operation of OTFs that has been left to be dealt with at Level 2. There is a wider concern that the expansion of organised electronic venues that would result from the new OTF category would lead to an overly complex regulatory framework which does not distinguish clearly between organised venues and OTC. We are concerned that the likely implications of such a reform have not been fully assessed. It is essential to ensure that market participants, regulators and legislators can all with confidence anticipate the impact of the introduction of an OTF category before a change of such magnitude is introduced.

OTFs will capture virtually all organised multilateral trading, such as inter-dealer voice models and some forms of multi-dealer request for quote (RFQ) platforms. As the Committee comments, it is important that the impact of the introduction of the OTF category is fully understood. The Government accepts the rationale for introducing the OTF category as a necessary part of the new market structure but agrees with the Committee that the restriction on using proprietary capital is problematic. For example, the majority of bonds and interest rate swaps are dealt in this way. The Government believes that while firms could reconfigure themselves to comply, a rigorous conflicts of interest requirement, equivalent to that applicable to a Multilateral Trading Facility (MTF), would better address concerns about operator neutrality. The Government will continue to work to try and ensure the proposals achieve their purpose, for example as a venue for trading derivatives in line with the G20 trading obligation, without disrupting legitimate trading models.

Pre- and post-trade transparency

We understand the thinking behind the Commission's proposals for transparency, in terms of equivalence of market models and investors' access to relevant information and terms of trade. The proposals relating to post-trade transparency are likely to be beneficial for investors and regulators. However, the pre-trade transparency proposals are flawed. It is important to acknowledge the markedly different characteristics of each sector of the market, in particular in terms of their liquidity. A one-size-fits-all approach to pre-trade transparency must therefore be avoided, and the Commission needs to be mindful of the potential of a negative impact on the sovereign bond markets and the corporate bond markets in the current economic climate. In particular, it is not clear that the price formation process will be enhanced by more onerous pre-trade transparency requirements in those markets. As negotiations continue, we urge the Government to ensure that a more flexible approach is adopted, to ensure that the right balance is struck between reaping the benefits of increased transparency and ensuring that the market is able to operate in an effective and efficient manner. Moreover, since the requirements to report transactions to regulators are extended by the recast regulation, the national authorities (such as the FSA and its successors) will be better placed to monitor and supervise market integrity, thereby enhancing market confidence and lowering the cost of capital. We acknowledge the evidence we have heard that the fragmentation of the market achieved under MiFID I has also led to a fragmentation in data collection, and therefore to a deterioration in data quality. We support the case for the creation of a timely consolidated information tape and urge the Commission to take urgent steps to bring this about.

The Government believes the MiFID review provides an opportunity to enhance market transparency. However, such requirements, particularly in non-equity markets, must be carefully calibrated and based on detailed evidence. The Government therefore agrees with the Committee's view that a one-size-fits-all approach must be avoided. For example, a transparency regime for derivatives and corporate bonds must take account of the diverse range of asset classes, whose trading characteristics can differ significantly. For many non-equity instruments, the process of matching a buyer with a seller requires trade terms to be negotiated, which would not be compatible

with the forms of pre-trade transparency that can be applied to equity markets. Failure to understand these issues properly and at a granular level could, as the Committee comments, impact on liquidity and the cost of capital. The Government agrees with the Committee that there should be flexibility. Pre-trade transparency requirements should be applied, as appropriate, on an instrument-by-instrument basis, and such requirements should be tailored to the business model of the relevant trading venue. We have also proposed an option whereby a competent authority could, subject to notifying ESMA, suspend pre-trade transparency requirements from a local market in illiquid trading conditions. The Government agrees with the Committee that a consolidated tape should be introduced to address the issue of data fragmentation.

Systematic Internalisers

Whilst we recognise the Commission's desire to provide greater transparency and equivalence between market models in the operation of Systematic Internalisers, we conclude that the regulatory regime set out in MiFID I has been unsuccessful, as demonstrated by the unwillingness of market participants to adopt the SI model. It would be undesirable for the reach of such a flawed regime to be extended further, as MiFID II proposes.

The Government believes that Systematic Internalisers (SIs) continue to have a role to play, though acknowledges the Committee's comments that this category has not been heavily utilised and some clarification of the purpose of the SI regime may be beneficial. The Government has proposed that any extension of the SI regime does not apply to illiquid instruments. The Government has also sought to ensure that, wherever possible, pre-trade transparency requirements for SIs are consistent with those for multilateral trading venues.

Algorithmic and high-frequency trading (HFT)

High-frequency trading remains a deeply controversial activity, and there is a wide spectrum of views and evidence as to its utility. Further research is needed in order to determine with any certainty the impact of high-frequency trading on financial markets and on the economy as a whole. To this end we look forward to the publication of the final report of the Government's Foresight project on the Future of Computer Trading in

Financial Markets. In the context of such uncertainty, whilst there appears to be a strong case for such devices as circuit breakers, we are concerned that some elements of the Commission's proposals may prove counterproductive. We are concerned that the scope of the Commission's proposals is too broad, and that the distinction between algorithmic trading and high-frequency trading needs to be more carefully drawn. In particular, the proposal to require algorithmic trading strategies to be in operation throughout the trading day is likely to have a detrimental effect on financial markets. We urge that careful attention be given to the proposals and their likely implications in this complex and controversial field.

The Government agrees that measures applied to algorithmic and high-frequency trading (HFT) should be firmly grounded in evidence about its real impact. As the Committee observes, it is also important to recognise the distinction between algorithmic trading and HFT. The latter is a subset of algorithmic trading. The Government supports robust risk controls to be put in place by those firms involved in automated trading or that provide sponsored access to automated traders. But we share the Committee's concern about the requirement to provide liquidity at all times which could deter some entrants to the market or create prudential risks for others by leaving them exposed to market movements when other participants are at liberty to withdraw. The Government has taken into account the interim findings of the Foresight project and looks forward to the final report.

Third country access

Whilst we recognise the legitimate desire to introduce greater harmonisation across the EU in relation to third country access, the Commission's proposals are deeply flawed. There is a risk that, if introduced, such provisions could lock third country firms out of the EU markets, which, taking into account the risk of regulatory retaliation, would have an extremely damaging effect on European financial markets, and in particular the City of London. Given that global financial markets are independent of geography, we believe this to be wholly impractical. We are pleased that amendments have been proposed in the European Parliament to correct the weaknesses of the Commission's proposal. Given the vital strategic importance of the UK financial sector, not only for the domestic economy but also for the EU as a whole, and also given its international character, we urge

the Government to work to ensure that any provision on third country access will not have a detrimental effect on the UK financial market or on the EU financial sector as a whole. We support the Government's view that lengthy transitional periods for existing firms would be essential.

The Government agrees with the Committee's comments on the global nature of financial markets and the importance of the financial sector for the domestic and EU economy. The Government also agrees that the provisions for third country access as proposed by the Commission carry grave risks of acting as a barrier to trade in financial services, undermining the principle of free movement of capital and impacting on the ability of EU firms to do international business. The UK has worked hard in Council discussions to amend the proposal. The Presidency's amendments have removed the equivalence and reciprocal access requirement, providing instead simply for a branching regime for third country firms wishing to provide services or activities to retail clients. We believe this regime will avoid the disadvantages and difficulties the Committee has identified with regard to the Commission's proposals.

Regulation of commodities markets

There is a divergence of views on the proposals for regulation of commodities markets. In our view, whilst the Commission's proposals could be a useful deterrent to market manipulation, there is also potential for a serious negative impact on liquidity, investor choice and price formation. Furthermore, the Commission's proposals will not eliminate the price volatility of markets such as those dealing in food commodities. Such volatility is dependent upon a range of factors, and is in particular driven by supply and demand. Beneficial as increased regulation may be, it can only provide a partial solution.

The Government supports greater transparency in commodity markets. We agree with the Committee that price volatility in commodities markets is dependent upon a range of factors – supply and demand reasons play a strong role in the direction of price movements. To ensure the orderly functioning of commodity markets and to help prevent market abuse (while avoiding the kinds of problems identified by the Committee) the Government favours the use of position management regimes by market operators and

national regulators, which include (but are not limited to) the ability to set position limits.

Investor protection and corporate governance

Whilst the Commission is right to seek to strengthen investor protection by building on the important steps taken under MiFID I, we conclude that its proposals as currently drafted are flawed. Restricting the ban on inducements to independent advisers will be unworkable, since advisers will simply take steps to avoid being classified as independent. A more consistent approach to consumer advice is needed to ensure that consumers are adequately protected. One model for this is the approach adopted by the FSA in its Retail Distribution Review, which deals with the status and remuneration of advisers generally, and prohibits all payments in the form of commission. In our view, this would be preferable.

We acknowledge the need to ensure adherence to good standards of corporate governance, but the Commission's proposed approach is overly prescriptive. We do not believe that the MiFID II package is the appropriate mechanism by which to seek to achieve the Commission's goals. If these provisions are retained, then it is essential that greater flexibility is provided so as to take account of the diverse size, capacity and business models of the range of market participants.

The Government agrees with the Committee that the Commission's proposal to restrict the inducements ban to independent advisers is not the right way to improve investor protection across the EU. Applying the ban in this way is likely to distort the market in that firms may simply stop classifying themselves as independent. The payment of inducements for financial advice can lead to conflicts of interest. As the Committee observes, this issue has been addressed domestically in the UK by the FSA via the Retail Distribution Review. The Government supports rigorous standards of corporate governance but agrees with the Committee that some flexibility is required in the approach taken in the MiFID review and believes this issue is being addressed as negotiations progress.

The role of ESMA and the power to intervene

We conclude that ESMA has a vital role to play in coordinating regulation of financial markets across the EU. However, whilst its rule-making powers are broadly accepted, there is less consensus about the degree to which ESMA should engage in direct regulation of the financial markets, as suggested in the Commission's proposals for ESMA to take on product intervention powers. There are also significant resource issues for such a small organisation, and there is a strong likelihood that ESMA will need to rely on leading national regulators, including the FSA and its successors, to fulfil its tasks. We reiterate our view that day-to-day supervision of financial institutions should remain at a national level, and that an EU regulator should only have the power to intervene in exceptional circumstances.

The Government agrees that ESMA has a strong co-ordinating role to play and that national regulators are best placed for direct regulation or intervention in markets.