HOUSE OF LORDS

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Inquiry on

REGULATION ON MARKETS IN FINANCIAL INSTRUMENTS (MIFID II)

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Witnesses: Mr Thierry Philipponnat and Dr Kay Swinburne MEP

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Members present

Lord Harrison (Chairman)
Viscount Brookeborough
Lord Dear
Lord Hamilton of Epsom
Baroness Hooper
Lord Jordan
Lord Marlesford
Baroness Prosser

Examination of Witnesses

Mr Thierry Philipponnat, Secretary General, Finance Watch; and **Dr Kay Swinburne MEP**, Member, European Parliament Economic and Monetary Affairs Committee.

Q15 The Chairman: Colleagues, this is the second session of our inquiry into MiFID. Je vous souhaite une très chaleureuse bienvenue ici, Monsieur Philipponnat. Bore da, sut ydych chi? Diolch yn fawr for coming today, Kay Swinburne. Thank you very much indeed for appearing before our Committee.

I remind our witnesses that we will make a transcript of this conversation. We will send it to you. Please correct it and if you have after-thoughts we would be most grateful if you added those because we will not write the report for a couple of weeks. You may have further thoughts which aid and abet the Committee in what we seek to do. We are being broadcast today, so please be alerted to that. I remind my colleagues to make any declarations that they feel are appropriate for the purposes of this Committee. I also thank our witnesses for two outstanding contributions. Dr Swinburne, your address to the BBA was enormously helpful. Mr Philipponnat, your excellent booklet provided us with so much ground and opportunity to ask questions today. If either of you would like to say any opening words, I will give you the opportunity early on.

My first question is simply: is MiFID necessary? How does it relate to other pieces of EU legislation which we should be conscious of? Dr Swinburne, would you like to start?

Dr Kay Swinburne MEP: I guess MiFID II, as a piece of legislation, is a really all-encompassing piece. It obviously covers a regulation and a directive. It is very extensive in its scope. I can see how it was very easy for people to pick holes in what has been produced because there is so much of it. On whether MiFID is necessary, I guess there are three reasons that I believe it is. First, there is a built-in review clause in MiFID I. I have here a large number of issues, some seven or eight of them, that needed to be addressed in the review as an official clause in Article 65 of MiFID I. So yes, that needed to happen and the timescale for that was also built in, which is why it is being brought forward now. We have also got the G20 commitments—on derivative instruments in particular but also on commodities—which have been agreed. In order to meet the G20 objectives, the EU single market obviously has to bring forward some legislation that allows us to conform with the obligations that we took on board at those meetings. Of course, we have had major technological advancements and developments since MiFID I. That technology has necessitated some changes and the updating of some of the rules, in particular of some of the venues rules. For those three reasons, it is timely that we have this review and it is necessary.

The Chairman: Mr Philipponnat?

Thierry Philipponnat: Yes. Maybe very briefly I can summarise what Finance Watch is about. Finance Watch is a public interest group based in Brussels that was founded after the call of 22 Members of the European Parliament in June 2010 for another voice in the debate about financial regulation that would represent the public interest. The initial 22 Members of the European Parliament quickly became almost 200 elected officials throughout Europe, representing all political parties. That is absolutely central. There is no partisan view in

Finance Watch. Today, Finance Watch is a membership organisation of 65 members that collectively represent close to 100 million European citizens. Our professional team comes exclusively from the financial industry, financial press or the lobby world in order to do our work.

I will relate that presentation of Finance Watch to your question. Key principles of Finance Watch are that capital allocation and financial services are essential for society and that the pursuit of private interests is not only legitimate but indispensable for the economy to function properly. Having said that, we also believe that there is something called public interest and that that is not the mere sum of private interest. That relates to your question about MiFID: is the review of MiFID I necessary—yes or no, and why? In a nutshell, our view is that MiFID I was founded on the belief that more competition would bring value to society. The whole question of the review of MiFID I is about whether that belief was well-founded and a number of actions should be taken to correct things that are perhaps not perfect, or whether we are going in the right direction. You have read our report. In our view, some very good things have been done. Competition is necessary to keep people on their toes. At the same time, we have seen some consequences of, among other things, market fragmentation, which in our view has led to betting and speculating in financial markets being more and more efficient and effective. Yet it has made less and less efficient the ability of financial markets to serve their main purpose, which is to bring together the supply of capital and the demand for it. At the end of the day, we strongly believe that financial markets are here to be a place where demand for capital from corporation enterprises and public entities can meet savings brought by private individuals. That is the purpose of MiFID. I will stop here on this question.

The Chairman: In a way that answers the question. Your view is that MiFID I was, in terms of effectiveness, mixed to say the least.

Thierry Philipponnat: Yes.

Q16 The Chairman: We will have opportunities to explore that. Dr Swinburne, you particularly linked MiFID to EMIR. Would you talk a little more about the European market infrastructure regulation and the importance of bearing it in mind when we look at MiFID II?

Dr Kay Swinburne MEP: Of course, the G20 commitment on derivative instruments was threefold. First, there was a requirement for all derivative instruments that could be centrally cleared to be so. That central clearing process was deemed to be a way of mitigating risk in the system. You would put it into one central place and obviously collateralise against it. Therefore, you would mitigate some of the risk of these derivative instruments, which obviously played such a key part in the collapse of the financial sector back in 2007-08. That was deemed to be a central premise of it but so also were the trade repositories, where all the derivative trades—wherever they were conducted—would have to be reported to a central repository. That would therefore give regulators the oversight necessary to know what contracts were outstanding in their jurisdictions. The third component of that G20 requirement was to move those derivative instruments that were currently traded OTC on to electronic platforms, where appropriate. Those words, "where appropriate", need to be fleshed out a little but that third topic is the one that gets dealt with primarily in MiFID. The other two are being dealt with separately under the European markets infrastructure regulation.

EMIR is well advanced. We have the level 1 legislation text already in place. We are expecting the technical standards to be drafted by ESMA, the European supervisory authority, by 30 September. That piece of legislation—that bit of it—is well advanced. Of course, they are two sides of the same coin. They relate to one another. In the way that the European legislation works, it has split them into two pieces of legislation, whereas in the US it all comes under the one Dodd-Frank Act. It is a little difficult to keep these consistent and in the same timeframe. My concern is that we need to make sure that we not only deal with the OTC derivative instruments for clearing, repositories and trading, but also look at the existing exchange-traded derivatives, of which there are many. They have no obligation at this point in time under EMIR to centrally clear. MiFID will tidy that up, which will give the obligation for derivative instruments, no matter where they are traded, to be centrally cleared. That will then meet the entire G20 commitment. But these two really are very much hand in hand. We need consistency across these two dossiers to make sure that derivative instruments across the board get treated similarly.

Q17 The Chairman: Thank you for highlighting that. Before I have Lord Hamilton come in, I am going to give both of you the opportunity to give a broad-brush approach to MiFID II, which will follow logically on from what Mr Philipponnat said before in your assessment of MiFID I.

It would help us if the two of you, particularly Dr Swinburne, could say where we are in terms of the European Parliament, the Commission and the Council and perhaps bring us up to date there. Then we will have Lord Hamilton. Could the two of you give us a feel for the strengths and weaknesses of MiFID II?

Thierry Philipponnat: The strengths of MiFID II are the fact that it addresses a number of issues in a very conscious manner, particularly on things like high-frequency trading where the issue is addressed in a very clear manner and agricultural and commodity derivatives speculation where the issue is also addressed. It has the merit of bringing up the issue of dark trading versus lit trading. In our view, this is a very big issue. The question behind it is whether we want markets to be meaningful places where transactions happen or whether we are comfortable with transactions happening in the dark. That perhaps is something we will come back to later but it is in our view indispensable.

The Chairman: That is a nice overview. Dr Swinburne?

Dr Kay Swinburne MEP: To put MiFID II in context, when MiFID I was being negotiated many argued—particularly around London—that it would cause great harm to the markets in London, markets would lose liquidity and financial entities would leave Europe, particularly London. Of course, the opposite was true. The findings of the City of London Corporation have been that, of all the jurisdictions within the EU, London has been the major beneficiary of MiFID I. When the new MTFs were formed, over half of the 138 of them were based in London. We have seen that the City of London has benefited from not only the number of jobs generated here because of this but also the tax revenues that have come with them. The lowering overall of the transaction costs for investors, from wider access to all these different venues and other EU markets, has obviously brought huge benefits to London, too. We have to look at MiFID II in that context. It is not all a bad threat to the City of London and the markets as a whole. We have to bear in mind here that we have an opportunity to make things better and more efficient. For me, it is all about looking for the investor and whether this meets their needs this time round. Some things in MiFID I did not quite get that right. Some of the dark versus lit discussion plays into that. We are at the stage now where we have the Parliament deliberating midway through the MiFID debate. The rapporteur produced his report with his amendments. The Parliament submitted its amendments on 10 May. It is such a big dossier that you should not be surprised to learn that 2,145 amendments have been submitted by parliamentarians.

The Chairman: So few!

Dr Kay Swinburne MEP: I submitted only 197 of them. It is one of those issues. The amendments that I put in centred on some key themes, in particular pre-trade and post-trade transparency regimes for the non-equity space. I have also looked carefully at the existing market structure for equities and tried to put some suggestions as to how things could be improved. Third-country provisions are still not covered adequately so there are a lot of amendments on that. I am sure we will cover that. On investor protection, I have taken a fairly strong, very UK-centric line in some of my amendments. On high-frequency and algorithmic trading, I could not let it pass without attempting to make what was in there a little better and more workable.

I think the Commission's document is a good starting point for the deliberations we are having. It was a strong document compared to some that I have had to work on in the last couple of years. I have to say that that is partly because it agreed with the Swinburne report, for which I was rapporteur a couple of years ago, so I may be a little biased. It had things that were in the report I authored as a pre-MiFID report, such as that all entities should come under direct supervision if they were major players in the market, particularly with direct market access. It brings an end to unfiltered sponsored access. It brings co-ordinated circuit breakers and brings about certain risk-management tools for venues that are not there at the moment. I really approve of a lot of things in there, particularly with regard to quality of data and things that will improve things for investors.

Some strengths of MiFID II as they stand are those I have just mentioned but also the strong access requirements. They really show that the Commission is committed to a competitive trading environment going forward. It is not moving back; it is still committed to that improved competition. It has introduced a new category of OTF, which given the US deliberations on the swap execution facility was at least necessary for certain different types of trading and certain different asset classes. Where it has gone with commodity derivatives is totally in line with where the G20 and the IOSCO task force have come out. It has that as a strength to play on.

There are quite a few weaknesses at the moment, but I will not dwell on too many of them, as most will be corrected by amendments that the Parliament has already submitted across the board. However, there are some real concerns about the pre-trade transparency requirements in non-equities. We need a lot more detail to make sure that we have no negative impact upon, for example, the sovereign bond markets. I would also not want to see the corporate bond markets disturbed, given that that is the main route to funding for corporates at this point in time in the capital markets. The third-country provision is really very weak and contradictory. It contradicts an awful lot that is in EMIR right now. We need to make sure that that is sorted. I believe that there are lots of unintended consequences where an attempt has been made to address the high-frequency trading aspect of this. As currently written, the proposal would mean that all buy-side firms that use an execution-only algorithm to put on their order would have to become market-makers and make two-way prices. That is obviously an unintended error and will be corrected through the process.

The Chairman: We are going to get into the nitty-gritty. In a minute I will ask Lady Hooper, but Lord Hamilton has a comment on the earlier replies.

Q18 Lord Hamilton of Epsom: Any system of regulation that you bring in effectively freeze-frames the situation as it stands in the market today. We are dealing with an extremely active market where very clever people are dreaming up different ways of making money and doing things. Are you happy that MiFID II has the flexibility to deal with all the instruments that will evolve in future that we do not know about today?

The Chairman: Mr Philipponnat? That is a tricky one.

Thierry Philipponnat: That is a tricky but excellent question. It is really the key to any piece of financial legislation. Our view is that if we try to get into the detail of every single product we can be assured that we will miss the next product invented one or two years down the road. That will create an opportunity for regulatory arbitrage and everything. That is why we fundamentally think that we should go to the root causes of the thing, make sure that the general framework operates for the benefit of the economy of society, and then the rest will be just a natural consequence. I would really favour a regulation that addresses the big issues as opposed to getting into the small detail of everything.

The Chairman: The wood for the trees, Dr Swinburne?

Dr Kay Swinburne MEP: I think it is about the balance between level 1 and level 2, and how the delegated acts will work. In theory, if we get level 1 correct, that allows the implementation to be a little more flexible. The balance is going to be critical in all of this.

The Chairman: To satisfy Lord Hamilton, do you think that that balance is about right at the moment? You have your doubts.

Dr Kay Swinburne MEP: I have significant doubts. From the amendments that I have read so far, I believe that the Parliament if not the Council will already remedy much of the balance and make sure that there is far more in level 1. We have already seen that the rule-making and technical standards written by ESMA are in their infancy. They are in their first round of writing these rules. Unfortunately—I say "unfortunately" because they had a lot of work to do—documents such as the AIFMD or hedge-fund management directive and the short selling regulation were very politically motivated dossiers in the first place. There were lots of grey areas left in level 1. That means that, in level 2, when it comes to writing those technical standards, it has proved quite problematic as to what is a political decision versus what is just implementation. In EMIR, we have taken level 1 and made it a lot clearer as to the role of ESMA and what technical standards it has to write. We can come into some detail on that here. We are going to have to specify in level 1 some significant parameters by which it has to take into account certain things. Particularly if ESMA is to define which markets need pre-trade transparency and which do not, we need to have some detail in level 1 to provide guidance.

The Chairman: I am going to invite Lady Hooper in, but I think that those areas that are of concern to you are the ones that we ought to scrutinise more. It would be useful to learn about those throughout this conversation.

Q19 Baroness Hooper: Before I ask my premeditated question, may I follow up on that? You said in your introduction that MiFID II was a response to a built-in review clause in MiFID I. Will there be a built-in review clause in MiFID II? Will we see a MiFID III?

Dr Kay Swinburne MEP: I am not very popular in the Parliament for saying that I firmly believe that there will be. Developments in the market are such that it will happen. There are too many things. We can of course have a review clause without having MiFID III, if those developments are not significant. If there are minor amendments, we can make them through the review clauses in there, but I believe that the market will adapt. It will transform once again and we cannot hold innovation back—nor should we want to. Therefore, I think we are likely to see a MiFID III. I suspect that there will be others dealing with that.

The Chairman: Would you like just a wink at that one, Mr Philipponnat? Do you think there might be a MiFID III?

Thierry Philipponnat: Most certainly, yes. There is no such thing as EU regulation that will exist until the end of the world.

Q20 Baroness Hooper: This may not be quite a sequitur, but transparency in all things is considered beneficial. How do you assess the impact of the Commission's proposals on trade transparencies? Should a distinction be made between pre- and post-trade transparency?

Thierry Philipponnat: Yes, a distinction should be made. Both levels of transparency are essential, but the technicalities may be different and they will certainly be different depending on the asset class you are talking about and the transaction you are dealing with. Certainly in the equity world, pre-trade transparency is essential if you want to have a market with a meaningful purpose that has all the information that is necessary for market participants to deal at a price that makes sense to them, which is why we think that a consolidated system, which is sometimes called EBBO, to show market participants what the best bids and offers are, is essential, certainly in the equity world.

In some other spaces, it can be very different, certainly in the bond market—you would have to distinguish between government bonds and corporate bonds—because the nature of those markets is different. The equity market is about fungible assets that trade all the time with various types of participants. If you look at the corporate bond market, some bonds trade once every other week. Does it make any sense to have pre-trade transparency when you have one line for €3 million—or £3 million or whatever—being traded twice a month? You have to distinguish. That is typically where we have to be very careful. It should not be a religion to be for pre-trade transparency or against it. The principle is clearly good, but then you have to distinguish per asset class.

In the world of derivatives, it is different again. Depending on whether you are dealing in plain vanilla or non-plain-vanilla derivatives—plain vanilla being classical derivatives with simple features—you will not have the same answer. Depending on the size you are dealing in, the answer is going to be very different as well. I would say that the vast majority of derivatives transactions should have pre-trade transparency, but there is a case for large transactions not having pre-trade transparency. The short answer is: yes in principle, but then distinguish per asset class and type of transaction and adapt to the reality of the market.

Post-trade transparency is absolutely essential. There should be a consolidated tape because information is vital if we want financial markets to have a meaningful economic purpose. Any trend that goes against post-trade transparency comes down to saying, “I don’t trust markets” and “I do not think that markets should concentrate information for the purpose of dealing”. If we believe that, what are we doing here? Why are we organising financial markets? I would almost see pleading for no post-trade transparency while being in favour of financial markets as a contradiction.

Baroness Hooper: I think that Dr Swinburne has suggested that we should be more cautious about pre-trade transparency.

Dr Kay Swinburne MEP: Like Thierry Philipponnat, I think that it is asset class by asset class. When it comes to equities, there are some very sensible reasons why you would want to refine the waivers on pre-trade transparency so that ESMA can make sure that they are being applied in the same way across all 27 markets. Certainly to date they have not been applied consistently across the equities base across all marketplaces. That gives us a much more level playing field, and in the equity space that is to be welcomed.

When it comes to non-equities, a real big issue is that in many member states we are starting with a blank sheet of paper because no rules are set for certain markets at this point. We have to make sure that we differentiate based on liquidity. As was just said, if a corporate bond is trading only once or twice a month, you would need to apply very different criteria to it.

The wholesale market is very different from retail bond markets, and we need to be very careful if we are talking about the wholesale market. When I talk to people in London, they typically think of only the wholesale markets, whereas if I talk to my Italian colleagues, they have a thriving retail bond market. I understand that last year the Italian retail bond market raised €716 billion, so it is a significant market for them. We cannot have this one-size-fits-all when it comes to transparency. There are strong arguments to be made that even in the bond markets, if you are looking at retail-sized orders, there is a probably a call that the markets can withstand pre-trade pricing and have transparency at that size of order. Once we get to the wholesale markets, I suspect that they cannot. It is what we do with the space between retail and wholesale and whether that intermediate space has any form of pre-trade disclosure. I think we can calibrate depending on asset class as to whether that needs to happen.

Baroness Hooper: What I find difficult is who decides that.

Dr Kay Swinburne MEP: A large number of amendments have gone in from the Parliament which try to distinguish based on different criteria: liquidity, size of order or volume. All sorts of parameters will go in. At level 1, we will try in the Parliament to have a definition of what ESMA needs to look at in order to come up with a definition for what needs pre-trade disclosure. I think it is likely that Parliament will opt in favour of ESMA making the decision, but at level 1 the parameters it has to use to decide that will already be defined so there will be no political decision on its part. It will be predefined in level 1. Whether that is done on size, retail versus wholesale or some more sophisticated measures, those debates are yet to be had in the Parliament. We start them next week, I understand. It is going to be an interesting dialogue.

On post-trade, things are very different. Even at wholesale size, if we had disclosure on a relatively rapid basis, post-trade could almost be a proxy for the lack of pre-trade transparency. If within a 15-minute window you had 80% of those trades reported, you would have a very good feel in the bond market for what the pricing mechanisms are and where the prices currently are. It could be a very good proxy. When people tell me that it could have a bad effect on liquidity, you have to look at things such as the TRACE instrument in the US. Now that TRACE has been introduced on a limited number of instruments, it seems to be having a positive effect on liquidity, rather than the reverse, as was anticipated. I think that we can learn from other jurisdictions on getting that right. I am firmly of the opinion that I would prefer to have information in the market rapidly about a large trade taking place, even if we have to mask the volume of that order. I have no problem with masking, so long as there is a declaration that a trade has taken place. Then people are at least aware that something they should be aware of has happened in the market. I think we can find a post-trade regime.

I know that AFME came to talk to you last week. It has a proposal on the table to try to calibrate this post-trade regime. I am convinced that there is a lot of merit in the proposals it is putting forward, and I hope that Brussels can be convinced that, now the industry has come together to produce a back-tested set of data, we can at least start to use that as the basis for future discussions.

Thierry Philipponnat: If I may add one thing on post-trade transparency, the impact on liquidity is one thing, and we could discuss it for a long time, but the quality of price formation is as important as the liquidity argument. If we do not have post-trade transparency, the market lacks vital information. If it lacks vital information, what is the purpose of the market?

Baroness Hooper: I think that Dr Swinburne has also stated that data quality needs to be improved.

Dr Kay Swinburne MEP: Yes, it needs to be improved across the board. When I started to write my report for the Parliament back in April 2010, there was a distinct lack of data on the equities space let alone on the fixed-income space. There has been a dispute as to what volume of trades take place in the OTC world—in the dark as opposed to the lit space—where the range of data goes from 13% all the way through to 40%. The fact that nobody can tell me whether the volume is 13% or 40% is shocking, and that is all because of the quality of data that is out there. MiFID I obviously fragmented the market—for me, that was a positive result in terms of competition—but it allowed people to report those trades to any venue, so you could report them on your own website rather than on an official source. That has had a very detrimental effect on data quality and on the ability to collate the data. Certainly colleagues from around the world find it fairly unusual that in Europe we do not have a consolidated tape for our trading records. I think that we are at the stage where we need to remedy that, particularly in the equities space, and the Commission's proposals about creating APAs—approved publication arrangements—are a step in the right direction. This will be a competitive situation and not a single utility model for a consolidated tape, but it will finally get the data to approved providers, who as consolidated tape providers will be able to pull that information together.

Within the Parliament, I have submitted a further amendment proposing that all consolidated tape providers be required to go to all approved providers in order to consolidate their information. If people go only to two or three providers, we will still have only a partially consolidated tape. I think that we need to give a nudge in the right direction. There are some huge vested interests in the data world, where a huge amount of revenue is being made by a large number of people for selling the data. I think that we need to have a legislative nudge in the right direction, given that we have not come anywhere close to having a market solution in the last three years.

On the fixed-income space, we are starting afresh and I think that we can set some parameters now for what data reporting needs to happen. To miss that piece of the jigsaw would be a serious flaw. At this point in time, it has taken AFME two years to produce the average trade volumes per different product. Each bank and each dealer could produce their average trade volumes for me, but they could not collate that information because no one had ever collated it. They have now done that, but I would like to see a tape of record so that there was a source to which people could go to know which products were outstanding. In this day and age, that would be a very significant step forward for investors.

Baroness Hooper: I wish you every success.

The Chairman: That was excellent. Let us press on with the next question, which is from Lord Hamilton.

Q21 Lord Hamilton of Epsom: First, I declare my interests as the director of an investment trust and of two international property funds.

I am a bit confused about the post-trade and pre-trade transparency proposals. When I ring up my stockbroker on rare occasions, he can tell me for any individual stock what trades have been done within half an hour or so before I talked to him—he looks them up on his thing and says, "100,000 shares changed hands at 100p". Does that fulfil the requirements for post-trade transparency?

Dr Kay Swinburne MEP: That would only tell you about the trades on whichever venues he subscribes to, which might be the stock exchange or one or two of the MTFs. Your stockbroker would be able to give you the information on the data that he subscribes to, but he would not have access to all the venues that might have traded that stock within the last half hour. What we would like to see is a consolidated form of data, which would look at not just particular venues but across the whole spectrum. There are 138 MTFs, so I expect that there are an awful lot of prices that your stockbroker does not see.

Q22 Lord Hamilton of Epsom: It would be quite a business gathering them all together. On pre-trade transparency, markets move so, if I say to you, "Yes, you can have these at 100p", I cannot guarantee that price for more than perhaps three seconds. I do not understand how you deal with pre-trade transparency in a moving market where the price goes up and down.

Thierry Philipponnat: There are two dimensions here: the actual information and the ability to deal. On the actual information, the issue is first, whether we want it and, secondly, whether we have the technology to consolidate the best bids and offers in the whole market at any point in time. As MiFID I led to a fragmentation in the market, there is clearly a big technological challenge in ensuring that we have all the best bids and offers at all points in time, but it is feasible provided that we want to do it.

The execution dimension relates to whether you are going to get the best bid—or offer, depending on whether you are looking to buy or sell—but there are then many issues behind that. One of those is algorithmic trading because, obviously, when there are so many trading venues, the trading cannot be done by hand so there is a requirement for the clever algorithm that will take the order to wherever the price is better. That is one dimension of it. The other dimension—looking at the same problem from another angle—is that we have built a system where we have fragmented markets and therefore prices diverged, as would have been expected, and then we have a system that brings prices back into line. I know that we cannot go back in history, but did we need to fragment markets and make prices diverge only to make them converge again? That is clearly a big question, especially in light of the fact that, yes, the cost per transaction has gone down thanks to that market fragmentation, but the cost per value—for buying the same amount of stock in money terms—has gone up. That is very interesting, because many of the trading, clearing and repository costs are per transaction, but when you think in per value terms, following MiFID I, the cost of the transaction has gone up.

There are many things behind your question, but I feel that those are the main points. It is essential that the broker has the right technological means of accessing the markets. I know that this was not the main purpose of your question, but if we link that to the question of algorithmic trading and high-frequency trading, a distinction must be made that was not made clearly enough in the Commission's proposal. Algorithmic trading and high-frequency trading are not the same thing; HFT is a subset of algorithmic trading, but it does not have the same purpose as the algorithm that your broker should and could have in order to execute your order in a professional manner.

Q23 Lord Hamilton of Epsom: Thank you. I think that I now understand that marginally better.

What is your view of the proposal to introduce a new category of organised trading facility? Is this needed?

Thierry Philipponnat: First, let us define what an OTF is. We know that MiFID I created the MTF, or multilateral trading facility. I would define the organised trading facility as an MTF with, on top of that, discretion for the broker over whether to execute orders and discrimination over whether to allow customers on the platform. My definition of an OTF would be a degraded MTF with fewer constraints.

What do we need that for? I think that, in proposing OTFs, the Commission had a good intention, which was to bring back the OTC market on market or on to regulated venues. In our view, that is a very good purpose or objective, because today—if I may digress for 20 seconds on this—as Kay Swinburne rightly said, discussions about the size of the OTC market suggest that it is somewhere between 20% and 40% but, regardless of the size of that market, the fact is that more or less half of the OTC market is dealt at standard-size or below-standard-size transactions and, if I remember well, 87% of the transactions involve smaller than large-in-size transactions. In other words, the purpose of the OTC market has been diverted. Its purpose was to allow transactions that are large in size to be dealt with over-the-counter because such transactions can have a market impact and, if done on the lit market, that impact would be negative—it would be bad for everybody. However, the reality of the OTC market is that the vast majority of transactions could and should be done on the lit market instead.

Coming back to the question about OTFs, I think that the purpose of the Commission in inventing this new category of OTFs is to do as much as possible to bring back that OTC market on market by creating a new type of venue that is slightly less regulated than the existing venues but still better than pure OTC. In our view, that does not serve the purpose because either we will have regulatory arbitrage with MTFs being degraded to become

OTFs, which in our view would serve nobody, or no one will use them. The right way of addressing the OTC situation is not to forbid OTC transactions—there are many situations in which OTC is justified—but to give a clear definition of what OTC transactions should be. In MiFID I, there was no clear definition of what OTCs should be. Recital (53) said that OTC should be for large-in-size transactions, but in the core text of MiFID I there was no strict definition. Therefore, without violating the law, business has gone OTC because there is more margin for dealers there than in lit trading, but that has been done at the expense of investors and retail customers. In our view, OTFs really are not useful and are not the right way of addressing that fundamental issue.

Lord Hamilton of Epsom: Are they going to happen?

Thierry Philipponnat: You should ask a Member of the Parliament, which I am not. I am not voting and have no power. I am just advocating.

Dr Kay Swinburne MEP: I have a slightly different take on the OTF. I think the Parliament's discussions have got slightly confused because at the moment the OTF is trying to do two things. It is trying to address the broker-crossing networks in the equity space that have developed post MiFID and are contributing to some of the dark trading that is taking place. That is part of Finance Watch's issues. The other side is the G20 commitment to move derivatives trading on to more organised electronic venues. It is very difficult to see how the existing venues can be made to work without degrading the current regulatory framework. I would not want to see them suffer in order to have the flexibility for derivatives trading. Indeed, over time, if we want to move some of the fixed-income trading to these organised venues, this is a good way of achieving that because it is the midpoint of moving the markets to a more sophisticated electronic format.

However, there are some issues. It all comes back to data and what we are working on. The OTC data is critical. If it is 40%, you would not want to maintain 40%, particularly in the dark, because it probably has an impact on price discovery, particularly on the equity space. However, only the UK collected data on OTC trades pre-MiFID, so the only data we have pre-MiFID are FSA data. The FSA suggests there has been no change in the quantity of trades done OTC before and after. I am a little concerned that we are confusing the picture by talking about the equity space and the OTF at the same time, and my suspicion is that the Parliament will suggest that OTFs are not appropriate for equities and will try to make sure that the equities broker-crossing network will move on to an MTF or through the existing SI model. I think there is growing recognition among the shadow rapporteurs and the rapporteur himself that the OTF category is probably necessary in order to give the flexibility in the non-equities space for trading and that that would be preferable to not having it at all.

Q24 The Chairman: Just before Lord Hamilton pursues that, with the FSA going who in the residual bodies will provide the kind of information that it is providing at the moment?

Dr Kay Swinburne MEP: It will continue to do that in its new format as the markets authority. It will continue to collate the data. It has a very sophisticated new trade-reporting system—I am trying to think of its name—on which it has just spent a large number of millions of pounds and which is one of the most sophisticated that there is. It has data at its fingertips but, sadly, most of the other regulators across the EU do not, so there is a question about whether this technology may be made available to other member states in order to have the same high-quality trade reporting taking place.

Q25 Lord Hamilton of Epsom: You referred to dark pools. There has been an increase in dark-pool trading that is detrimental to fairness in price formation. I read in some of the briefing that we were given that the US, Canada and Australia also have concerns about dark pools. How important is international co-operation on this? Do we need to be in step with the US authorities and so forth? Does it matter if we are out of step? I cannot get a handle on this. Given that we are talking about a global marketplace, how important is it that we are all doing the same thing at the same time?

Thierry Philipponnat: I think that we are talking about the global marketplace from the perspective of who is acting. Actors are clearly global and are acting in different financial markets, but the reality is that financial markets are still national. There is the UK equity market, the US equity market, the Canadian, Italian, French and you-name-it equity markets. Effectively, a dark pool is going to be concentrated on or specialised in a certain market, in which case what really counts is the regulation in that part of the world. Yes, we have a global industry and a global market, but the reality is that financial regulation for specific markets to a large extent remains national.

Q26 Lord Hamilton of Epsom: Can you give an example of something that is traded in a dark pool so that I can get a better handle on what it is about?

Thierry Philipponnat: It can simply be shares. Dark pools in European markets represent about—there is always debate about statistics—6% of trading volumes. I have had many discussions with large institutional investors about this. A main institutional investor that wants to sell a very large block of shares does not want to have a market impact, so will therefore put it in a dark pool. Presented like that, a dark pool can have a meaningful purpose. In a way, it is just what we were saying earlier on. When you have large or very large transactions, you do not want to show your interest to the market because otherwise you move the market and it goes against you.

The vicious circle we have entered in the European markets, and more in the US market now, is that because of high-frequency trading, there is a crowding-out effect for large institutional investors. They want to hide away from high-frequency traders and will therefore have a tendency to go to dark pools or the OTC market because they are tired, to put it mildly, of being front-run by high-frequency traders. They know that the minute they put an order in the market, it will be detected, someone will get in front of them and the quality of the execution will be worsened because of that. Therefore, they want to hide from the market, and they will have a natural tendency to go to dark pools or to the OTC market.

Lord Hamilton of Epsom: So I suppose that if I have traded 50 million shares in Shell through a dark pool, I go in for post-trade transparency. People know about it after it has happened; they just do not know about it beforehand.

Q27 Lord Jordan: What do you see as the real purpose of high-frequency trading? Do you agree that the increased use of automated trading can threaten the orderly functioning of markets in certain circumstances, for instance where algorithms overreact to market events? How would you assess the present MiFID II proposals in relation to dealing with the problems of algorithmic and high-frequency trading?

Dr Kay Swinburne MEP: I will have a stab here. It is difficult when we talk about high-frequency trading to talk about it in one big lump. Typically, anyone with access to a broker who has access to up-to-date technology will be executing their orders through an algorithm. It is across the board. These will be high-frequency algorithms, because they operate at fairly high frequency. It is difficult to talk about high-frequency trading without bringing everyone into the envelope, so I think that we have to distinguish trading strategies here. There are those people who have an operating strategy that is in effect only posting orders either on the bid or on the offer continuously throughout the day. At the end of the day, they have no position; they are flat. They are providing liquidity. It is the equivalent of what would have been the market-maker function in days of old—even in the very old physical market, you would have the market makers, who would be flat at the end of the day. This is the function that some of these strategies are operating.

If we define those strategies as needing special treatment and say that they need to have some obligations attached to any benefits that they have, that provides some stability into the system, because they would be regulated. At the moment, most of those providers of liquidity are not regulated in the market. They make up some 40% of the volume of European traders. In the US, the equivalent number of those strategies is 70%, so the US is far ahead of us in terms of the number of strategies, but the players typically are the same; they are the same global players who are providing this liquidity in the markets. In Europe, the first thing that we need to do—and this regulation covers it—is to make sure that those entities that are providing that liquidity are regulated, so that any orders and messages that they put into the system are monitored and regulated with oversight by the national regulators. At the moment, that is not the case with most of them. That is a simple first step for making the entire structure of the market safer.

The other steps that you can take are to strengthen the venues themselves, because with this higher number of messages going through it is more likely that you will have a collapse in the system. The outages that you see and hear about and the flash crash in May 2010 have been instances when you see an exaggerated effect of these algorithms all working off one another. A co-ordinated circuit breaker, which works not just across the exchange but across the MTFs and other trading venues, is an appropriate measure to put in place. Under the new proposals, the venues will have to tighten up their controls over the people who have access to their markets, so you will not be able to have unsponsored filtered access; you have to have somebody filtering your orders and checking that you are behaving in an appropriate manner for that venue. I think that that is fairly reasonable; I do not think that anyone is saying that these proposals are not reasonable.

The question is whether you should put obligations on these people who are operating these strategies where they are flat at the end of the day. Should you have some form of obligation on them as a market maker? If they are making markets, should they be persuaded to make markets through all market conditions or through most market conditions? I do not think that you can force anybody to stand in the way of a falling market. However, you can force them to stay within their risk parameters, so within pre-arranged conditions they would be obliged to stay in the market. That is much the same as was always the case at the London Stock Exchange or the London Metals Exchange in days of old. I think that we can start to put in place some processes that will level the playing field a little.

Fee structures are my biggest concern. In the last three years, they have favoured those who are operating these strategies, providing volume of orders to the market, rather than putting a premium on those who are executing a large size of order. The orders get spliced now into very small orders, which is increasing the friction in the market. I think that we can make the markets a lot more efficient by persuading them to price things based on volume of orders rather than on frequency. I think that we can change fee structures quite easily without interrupting the market too much.

Thierry Philipponnat: I take a slightly different view of HFT. I think HFT relies on confusion between volume and liquidity. Liquidity is a very simple concept, which consists of having someone willing to buy when you are looking to sell and someone willing to sell when you are looking to buy. Volume is just volume. If you listen to the argument of the HFT professionals and lobby when they say that they need speed to provide liquidity, they say that, if you remove speed, the spread that they will be quoting will not be as tight. Effectively what happens in the market is that HF traders can run 10, 100 or sometimes 1,000 times faster than the people who actually need the liquidity, who are the institutional investors. I encourage you to read this piece of research—entitled "High frequency trading - credible research tells the real story"—from Schroders, which is certainly a brand name in this country. The Schroders report explains very well that, when it wants to sell 5,000 shares of stock, it gets attracted by a nice bid for 200 shares. It can hit the 200 shares and the remaining 4,800 disappear and get replaced very quickly at a worse price. However, as the execution was already sent, there is no time to remove it and so the remaining 4,800 shares are bid for at a worse price, which effectively means that the average price of execution has deteriorated. That is not me speaking but Schroders. That is the essence of HFT. That is what we mean when we say it does not bring liquidity but volume.

As a former executive committee member of the live market not very far from here, I signed many liquidity provision agreements with many market makers. Some of them were firms that are currently HF traders. A liquidity provision agreement is about quoting a size for a certain amount of time with a certain depth for a certain period of time during the day. The two key issues are that the liquidity provider does not have the right to walk away from the price that he or she is quoting when the client wants to trade. When the HFT professionals say that we need speed to make markets, they mean that they need to be fast enough not to stick to a price when the customers want to trade. I am sorry—I know that this is not a popular thing to say—but this is exactly the opposite of what liquidity provision is about. That is why liquidity providers get paid. It is normal that they should get paid. It is a difficult and risky job. But this is about, "This is my price. If you want to trade, you may". It is not about, "This is my price. You wanted to trade but I walked away from you", or, "You could trade in very small amounts and the rest of your order was executed at a worse price". That technique is called smoking in the market and is the way it works all the time.

There are two main strategies in HFT: the one that I have just described and another one—this is perfectly legal, and there is no market abuse in the legal sense of the term—which philosophically speaking is technological front-running. This involves detecting trading patterns used by large institutional investors, getting in front of whoever is trading with a certain pattern and benefiting from that. That is trend following or front-running and it is done in such a clever way that in the vast majority of cases it is not illegal. Does that mean that it benefits investors? My clear answer is no.

The Chairman: Colleagues, we are short of time. I apologise to Lord Jordan, but may I press on with Lady Prosser?

Q28 Baroness Prosser: I return to third-country access, which you touched on a little earlier. You are no doubt fully aware that the Commission is proposing to create a harmonised framework for granting access to the European market to third-country firms and market operators. Can you tell us a bit about how you assess the Commission's proposal? I noted that when you, Dr Swinburne, were talking about MiFID II, you said that you felt that MiFID II does not cover this issue adequately.

Dr Kay Swinburne MEP: There are some real issues with the text on third countries as they are dealt with under MiFID and EMIR. It does not sit very well with what was already agreed under the level 1 text for EMIR, which causes me great concern because the two have to be exactly the same in terms of output. There is a real problem here. In EMIR, we certainly took away many barriers by taking away language about reciprocity because reciprocity is a very high hurdle and is likely to be in contravention of WTO agreements, let alone anything else. Why they have put it in, we do not quite know. I know that many Members of the Parliament have amended the text to remove it and to improve the third-country issues. Strict equivalence and reciprocity would effectively close down our markets, which would be in nobody's interest.

When it comes to the derivatives and commodities trading G20 commitments, we want to be as close to other jurisdictions as possible, but the reality is that MiFID II has a number of issues on which we would not want to be standardised with the rest of the world. You would not want any form of equivalence anyway, so you have to have different regimes for different parts of the dossier. Markus Ferber, the rapporteur, has put down an amendment that recognises a transitional regime so that existing regimes between member states and other areas will continue to be in place for as long as necessary or until one year after the Commission has made a positive or negative equivalence decision. If the Commission does not get round to making an equivalence decision on, for example, Bolivia, it would not stop the UK or any other member state trading with Bolivia under existing arrangements. That contrasts with the Commission's text, which suggests a two-year cut-off date from the date of adoption. That could have a very detrimental effect if we had not got through all those countries in that time. I have put down a complementary amendment that suggests we start working on the most important jurisdictions first, so that, instead of looking at the easy wins, the Commission looks first at the biggest jurisdictions that we trade with most so that we have agreements in place with the US, the big Asian markets and the other big players. The credit rating agencies went for the easy ones first. They went for Russia and China because they knew that they were not going to be equivalent and that was an easy decision to make. They still have not done the US and have an extension to do so. I want the Commission to go for the most important ones first.

The Chairman: Mr Philipponnat, do you have anything to add to what Dr Swinburne said? Otherwise I will invite Lady Prosser to move on.

Thierry Philipponnat: The short answer is no.

Q29 Baroness Prosser: The Chairman welcomes that, I am sure. What is your view of the Commission's proposals to strengthen the role of ESMA? Where does the appropriate balance lie between the responsibility of ESMA and that of national regulators? Dr Swinburne, you have stated that, "much is left to ESMA in how it writes technical standards regarding definitions of liquidity and market model and where they choose to set waiver levels". Should such detail be added to the level 1 regulations?

Dr Kay Swinburne MEP: You would probably get a very different answer from me, a British Conservative MEP, about what I perceive the role of ESMA to be than from some of my colleagues, who are a little more enamoured with the prospect of a single overseeing entity. I believe that ESMA's value is in creating a common rulebook for financial services regulation as a whole. One of the real problems with MiFID I was that different jurisdictions interpreted it differently. ESMA will ensure that there is one interpretation and that the rulebook is enforced across the entire 27 member states. That is positive. It will be writing the rules. It will be writing the technical standards given to it under the delegated acts. We have some safeguards here, but level 1 is where we need to specify the detail. Under Articles 290 and 291 of the European treaties, the Commission is allowed to delegate under certain circumstances—delegated acts and implementing measures—but ESMA cannot make political decisions or have any discretion. Those delegated powers have definite time periods. ESMA's role is very restricted and tightly controlled. When we set up these three supervisory authorities, they had very tight rules. In practical terms, that dictates the balance between level 1 and level 2, as we have already said, and level 1 should not simply indicate that waivers should be applied to pre-trade transparency. In level 1, we need to set the conditions for that waiver to assess market size, volume, liquidity or a combination of all three. We would have to set that in level 1. It is the balance that is important.

The Chairman: I invite Mr Philipponnat to respond to Lady Prosser.

Baroness Prosser: We understand that you are in favour of new powers being granted.

Thierry Philipponnat: I shall add a little perspective. We feel that there is a political debate, which is not our mission, about the single market and financial integration. If the EU believes that there is a need for a single market and that financial integration is a valid purpose then, regardless of everything else, you need a supervisor with a mission to look at the different markets and make sure they become integrated. We are very conscious that our leaders do not always address the fundamental political issues, that debates are very complicated and that we are not going into this debate now. This is the foundation. If we say that we want a single market, we need an authority that will co-ordinate the different markets in co-operation with national supervisors which, by definition, are closer to the ground and know the specificities of the local market much better. That needs to be co-ordinated at an EU level. Again, I am highly conscious of all the political issues behind that, the human issues, the issues of human and financial resources and the power struggles between people—c'est la vie, as that happens everywhere—but if we are here to define the ideal framework, if we believe we want a single market, we need a regulator that will co-ordinate everything. It is quite possible to say, "By the way, we do not want a single market", but that is another debate I am not getting into.

The Chairman: Let us go to our last two questions.

Q30 Lord Dear: Can I turn your attention to the regulation of the commodities markets? MiFID II proposes to introduce rules on the regulation of commodity derivatives markets to support liquidity, prevent market abuse and improve orderly functioning. How do you assess the new regime? Do you agree with the view that MiFID presents "an opportunity to curb excessive financial speculation on food prices and ensures that the commodity derivatives markets fulfil their intended purposes of enabling hedging and price discovery"? It would be helpful if you also added a comment on Finance Watch's proposals in this regard.

Thierry Philipponnat: Commodity derivatives markets, in particular agricultural derivatives markets, are useful. They have existed for a long time. They should exist because they serve a meaningful purpose of hedging for market participants, such as institutions or people who have a normal, natural economic interest in producing, selling and buying commodities in general and agricultural commodities in particular.

There are three points that I want to make. First, the financialisation of commodity markets is a perverse—and I mean that—phenomenon. Why do I say that? Financial markets are about investing. Investing is about bringing capital to productive use, yet none of the money put by investors into commodity markets goes to productive use; it remains in the financial system. This is not investing but betting. That is the first thing to say. Secondly, all serious studies—there are plenty of them—show that somewhere between 20% and 30% of speculation on agricultural commodity markets is useful or necessary for price formation and acts as the counterpart to hedgers. A farmer is willing to sell a crop forward. Speculators buy the crop forward. It makes sense and that all happens. When you have a market where, as is the case today, about 70% of agriculture derivatives positions are being speculated, the market gets distorted. That is not only because prices are being pushed up—they are, but that is not the only problem. The other problem, which is just as important an issue, is that the economic meaningfulness of the market for natural hedgers has at least diminished if not disappeared. The price at which that hedger is buying has less and less economic meaningfulness. That is a fundamental problem. Last but not least, today there are about $500 billion—I am sorry my numbers are in dollars—of financial products linked to commodity markets. There is no way that that can have no impact on the market. That is very detrimental not only to the price formation mechanism as I have just explained but also to the actual level of food prices. I am not sure that we have time to get into that, but in commodity markets the future price drives the underlying physical price, whereas in most financial markets it is the other way round. I am happy to go into that if you wish.

The Chairman: Perhaps we had better pause there because otherwise we will not get a chance to go on. I am particularly grateful for your answers but I will come back to that at the end. Dr Swinburne, do you have a comment?

Dr Kay Swinburne MEP: I can be quite short on this because I believe that commodity markets are global and should be regulated as such. I look to the IOSCO task force and its results. I am glad that the Commission has effectively transposed the IOSCO task force findings into MiFID as it stands, with more transparency and more identifiers giving regulators more oversight. This needs to be globally done, so I do not wish to deviate from IOSCO's proposals.

Q31 Viscount Brookeborough: Can we look briefly at investor protection? AFME argue in favour of "investor protection, appropriately addressing institutional and retail needs". To what extent does MiFID II meet this objective? Secondly, Mr Philipponnat, you say in your booklet that there are flaws in the current proposals. Would you like to elaborate?

Thierry Philipponnat: Sorry, I forget where that is.

Viscount Brookeborough: Sorry, that is on page 58.

Thierry Philipponnat: The main point is that, as is very well tested in this country, inducements are about not trusting that consumers realise that they are buying a service and should pay for it. Correct me if I am wrong, but the UK has tested that transparency on inducements is not sufficient to stop unsatisfactory market practices. This is really fundamental. Inducements should be banned, simply because they are a way of hiding the margin that is perceived by product manufacturers or distributors as the result of the work that they do as sales. Once again, if we believe that this is about a free economy, I have a real problem about building a system where we cannot trust the customer to say, "I understand that I am buying a service and therefore I should pay for it". Transparency of inducements is not sufficient because the reality of financial products is that you have a leaflet about the size of this one but nobody reads the fine print. It does not effectively protect the consumer.

Viscount Brookeborough: It is really about independence because the seller is in this case an independent person who is not necessarily working for the buyer.

Thierry Philipponnat: Absolutely.

Dr Kay Swinburne MEP: The Commission proposes to introduce a distinction between independent and other types of advice. That only tackles inducements on independent advisers. It does not address any of the issues on tied agents, where the issues are just as problematic as any other form of payments being made. It does not address a level playing field and certainly does not try to get one system across the EU. I am not advocating that one system across the EU is necessary, but we need full transparency. If we cannot get one system, and if the retail distribution review proposals that I have put in as amendments do not carry any traction with the European Parliament, as I suspect they might not, then the solution is a hard disclosure regime, no matter where the advice comes from, within MiFID so that all advisers, whether they are independent, dependent or tied, are subject to the same disclosure of every level of fee that is made. It is certainly not one or two fees. We have put in a template as an amendment that has over a dozen disclosures required. I was very surprised at how many fees are hidden across the board and in all the different models. We need disclosure.

Viscount Brookeborough: Many of the people who invest in these markets have really no knowledge of the market at all. As we have seen from how complicated it is, it is almost impossible for them to fully understand it. There will always be this issue.

Dr Kay Swinburne MEP: There will be, but disclosure is definitely the way to go. It has to be very definite disclosure: firm things that have to be disclosed. If you call it something slightly different in a different jurisdiction, they will avoid disclosure. We need to have a definite decision on what disclosure will mean and how transparent it is. To wrap up on investor protection, AFME has argued about addressing institutional and retail needs with regards to investor protection. At the moment, best execution applies only to retail. I would like to see that extended so that those who are executing on behalf of institutional investors also have a best execution principle applied to them so that they also have the best prices for their investors.

The Chairman: Colleagues, this has been a fascinating session. I apologise to colleagues especially on the left-hand side of the table for either abbreviating some of the questions or missing them out. I turn to you, our witnesses. As I said, we will make a transcript of this conversation and send it to you. I hope that you can not only correct that but also supply us with written answers to those questions which we simply did not have time for, if they are not available in the two excellent pieces that you have already submitted to us. This Committee has a collective headache on this very difficult dossier of MiFID II, but you have been the paracetamol in helping us clear our heads and better understand what confronts us. I am inspired by Dr Swinburne. I would like this Committee to submit amendments of our own to swell the total before the European Parliament to 3,000, if we get our report out on time.

Dr Kay Swinburne MEP: I would like to encourage this Committee to scrutinise the delegated acts. That is a very big unknown. These delegated acts will be a critical new phase which your Committee could do well to scrutinise for us.

The Chairman: Thank you for that advice. I conclude the session with our sincere thanks. You have tackled a very difficult dossier. We are most grateful to you. Thank you both for coming over today. With that, we conclude the session. Our third and final session is on 12 June. I close the meeting. Thank you very much.