HOUSE OF LORDS

EU Economic and Financial Affairs Sub-Committee
MiFID II: Getting it Right for the City and EU Financial Services Industry
Oral and Supplementary Written Evidence

Contents

Professor Emilios Avgouleas, University of Edinburgh and Professor Niamh Moloney, London School of Economics – Oral evidence (QQ 33-50)

Evidence Session No. 3. *Heard in Public.* *Questions 33 - 50*

TUESDAY 12 JUNE 2012

Members present

Lord Harrison (Chairman)
Viscount Brookeborough
Lord Flight
Lord Hamilton of Epsom
Baroness Hooper
Lord Jordan
Lord Kerr of Kinlochard
Lord Marlesford
Baroness Prosser
Lord Vallance of Tummel

Examination of Witnesses

Professor Niamh Moloney, London School of Economics; and **Professor Emilios Avgouleas**, University of Edinburgh.

The Chairman: Colleagues, this is the third and final session we have on MiFID II. I am very pleased to see before us today Professor Niamh Moloney from LSE and Professor Emilios Avgouleas from the University of Edinburgh. We are grateful to both of you for coming to us today for this session. I remind you that it is being broadcast. We will make a transcript of the exchange between us today. We will send that to you and would be grateful if you could look at it and correct it. Indeed, if you have further thoughts—normally, when you walk out of the room, you say, "I wish that I had said that"—would you be kind enough to convey those to the Committee? Next week, we will tackle the information we have already had from the earlier two sessions. Really, the more information and thoughts that we have the better: they will be extremely useful when we come to write up our report. I do not know whether either of you want to make an opening statement, but Lord Marlesford will ask a first question on the generality of MiFID II.

Q33 Lord Marlesford: Professor Moloney, you have been very critical of MiFID II. It would be very helpful to have your assessment of its strengths and weaknesses. Given that it is a controversial area, how realistic do you think the proposed timetable is for getting agreement on it?

Professor Moloney: Thank you. I made a criticism of the measure in an article that I wrote with another academic, Guido Ferrarini. If I can push back from the article a bit, I think that, generally, MiFID II is a good measure. We focused on a particular issue in the article but overall I think it is good. The reason why is that MiFID II is all about fixing the regulatory perimeter for financial regulation—if you like, what is inside and outside of the fence. Prior to MiFID II, how you regulated trading markets was really all about shares: that is, equity trading on certain kinds of formal venues and then the over-the-counter markets. It was really all about how shares traded either on formal venues or informally between investment firms. MiFID II takes that model and pushes it out very extensively. It is capturing more venues and also bringing in bonds, derivatives and other kinds of securities. In principle, that idea is a good one. The financial crisis told us that parts of the financial system are 'dark' and we do not know very much about them. MiFID II is part of the process of dealing with that. The second thing that is good about MiFID II is that it focuses—again more than MiFID I did—on the retail and consumer markets and it looks at investor protection. That is a good thing. The third good thing about MiFID II is that it has emerged from a pretty sophisticated process. There has been a long impact assessment, two or three round tables and an extensive consultation. As a piece of legislation, it has gone through quite a thorough process.

The difficulty I have with MiFID II is with respect to share trading, which is where an awful lot of the controversy is at the moment. It has overcomplicated the issue by increasing the number of venues that are regulated under MiFID. My view is that it is better to be simple in financial regulation: focus your resources on enforcing and supervising rules that are as straightforward as you can get. On the share-trading side, MiFID II is adding additional venues. As soon as you add different areas where you are regulating or where shares are traded, you open up possibilities for implementation problems, market confusion and arbitrage between different venues. That is the major concern that I have with it at the moment, in particular the issue of the organised trading facility.

The Chairman: Professor Avgouleas, what are the strengths and weaknesses of MiFID II?

Professor Avgouleas: I think that it overelaborates when it comes to classification of trading venues, but overall MiFID II is a very positive development. The regulation for the organisation of investment markets in Europe and the provision of investment services did need an overhaul. The previous regime had loopholes, some of which were exposed in the course of the recent crisis and others had been identified even before the crisis. As technological innovation and human imagination advance, they merge into what we call financial innovation. Regulation and regulators are bound to play a catch-up game. Overall, this is a very positive development.

The problem with it is that, when it comes to trading venues, I am not really sure why, for instance, organised trading facilities—which are broker-dealers to all intents and purposes—have to be stripped out from the proprietary trading function and just keep the crossing function, and so totally change and re-engineer their business models. Would it not have been better to simplify things by saying, as Professors Ferrarini and Moloney do in their article, that all venues where trades take place on exchange are multilateral trading facilities, whether they are operated by an exchange or a broker-dealer and all these markets should be regulated? Then we could have the OTC market, where broker-dealers could offer order crossing services and also trade on a proprietary basis subject to best execution rules. I have not assessed the compliance costs, but I assume that they are lower than imposing a new business model on a business. It is not clear why that analytically very simple structure cannot be implemented and instead we need to overelaborate things. There have been impact studies, but I have to admit that I do not think that the impact study makes a convincing case for this overelaboration of trading venue classifications.

Q34 The Chairman: Professor Avgouleas, Lord Marlesford asked about the proposed timetable. It would be very useful to hear from both of you about that. I would also be obliged if you could fit MiFID II into the existing framework that we have from the European Union in terms of the market abuse directive and the legislation on OTC derivatives and short selling.

Professor Avgouleas: I think that when it comes to interfacing with other pieces of European legislation, MiFID II is a resounding success. Derivatives trading and structural products trading is moving on exchange because of G20 decisions but also because they were at the heart of the crisis. In many cases, there is no other way. There is going to be much bigger interoperability and accessibility of central counterparties and clearing systems. The new market abuse regime is closing loopholes when it comes to OTC trading of financial instruments. MiFID II is providing the institutional infrastructure for these changes to come into force and be implemented and enforced successfully. It also provides the institutional and legal infrastructure to implement changes in a number of other areas like short sales or CDS trading. So in terms of interfaces with other pieces of European legislation, MiFID II is a resounding success.

Of course, taking a more holistic view when it comes to the market abuse regulations rather than those adopted by the first market abuse directive makes absolute sense because there are so many things that we did not know when the first market abuse directive was enacted. On the other hand, as some of you might know, I have been a very staunch supporter of private rights of action for market abuse. As a result, I am very sceptical about the effectiveness of criminal sanctions. I understand that threatening somebody with imprisonment is a strong deterrent. However, to convict anybody you require intent. I am not sure whether intent in the cases of market manipulation and insider dealing can be proved unless circumstantial evidence is adduced. Then there are a number of issues regarding human rights protections. The same applies to the proposed offence of the attempt to manipulate markets. Sometimes, it will be easy to identify evidence that, for instance, a trader or a trading house is building positions in the spot markets and commodity markets, probably with the purpose of manipulating the market for gold, zinc, silver or some other commodity. At other times, they might just have predicted that market prices would go up and then, as any reasonable business would do, built their stocks in the supply of physical commodities and their derivative positions early in order to ride the wave of rising prices. It is not clear how you could separate the two activities.

The Chairman: Let us pause there. Professor Moloney, could you just say something about the proposed timetable and whether it is realistic, and then perhaps deal with the framework that we have at the moment and with MiFID II?

Professor Moloney: Yes, I think the timing is ambitious. My understanding is that the Council was supposed to reach a common proposal in the past number of weeks and has not been able to do so. Just yesterday or a couple of days ago, the European Parliament produced, I think, close to 1,500 amendments to MiFID II. It is simply not practical to think in terms of the Council and Parliament agreeing a common position any time in the immediate future. The Council and Parliament seem to be quite apart on a few issues.

My view would be that this is an absolutely fundamental piece of legislation. Over the crisis, we have seen various pieces of legislation that have been rushed, and the effect has been confusion. What will happen is that the supervisory authorities will need to sort out a lot of the issues at level 2. My strong view is that there is no immediate rush on this. This is not crisis-era legislation: it is not Basel III and it is not about rescuing banks. There is no immediate panic to get this done. With Cyprus taking over the presidency for the next six months, my sense is that it would be much better to roll this out and allow the Council, the Commission, the Parliament, the industry and other stakeholders to look at it slowly. It would be a real mistake to rush this.

That links into the Chairman's question about how MiFID II fits with other pieces of legislation. This is a foundation measure that establishes key definitions on what constitutes a regulated market, an MTF and an OTF, and those definitions will then be repeated across all the major measures. If there are problems with MiFID II, it will have a knock-on effect on the legislation on short selling, over-the-counter and so on because they are all very closely related. That is one point. The second point is that they work pretty well together. One difficulty with EU regulations is that you have all these silos and different rules operating differently. Over the past year, there has been an effort to run these broadly in parallel. I think they have similar objectives and are going in a similar direction. As a package, I think it works pretty well.

Q35 The Chairman: Looking to the future, Professor Moloney, you talked about how "a driving concern appears to be the 'future proofing' of MiFID against future changes to the nature of organized trading and to address current and potential regulatory arbitrage risks". Would you just elaborate a bit on that?

Professor Moloney: Comparing MiFID II with MiFID I goes to the issue. When MiFID I was being negotiated, the huge question was what a systematic internaliser was. That became the flash-point for a massive debate between the stock exchange and, essentially, brokers. This is all about territory for trading securities. Back in the early 2000s, the flash-point was systematic internalisers or, in other words, those investment firms that, when someone puts in an order to trade a share, instead of sending it to the London Stock Exchange would simply trade against the stock of shares that they had. That was the flash-point and that is how we ended up with these hugely complex provisions about systematic internalisers. Now, there are 12 systematic internalisers and they represent 2% of European equity trading. Nonetheless, we have a highly specific, highly complex set of provisions in MiFID I. My fear is that MiFID II may be doing something similar with the big flash-point over the past year and a half, which has been broker crossing systems. Those are sort of like systematic internalisers but they do something a little bit different—if I put in an order to buy a share, the firm simply crosses that order with another client's rather than trade against its own book. It is the same concept and has become the big flash-point. Hence, we are getting the OTF. The difficulty is when you put something like that into primary legislation and it reads across into EMIR and the short-selling directive. My fear is that there is this concern to sort of grab into the future any possible kind of venue when I am not sure that that is necessary. I think we would be better off with clearer categories.

The Chairman: Perhaps Lord Vallance would be kind enough to pursue our old favourite, the systematic internalisers.

Q36 Lord Vallance of Tummel: This is a specific question. Can you explain what you meant in your article when you said that, "the fine-tuning of the SI regime should clarify its application and limit opportunities for gaming"? Can you tell us more about that?

Professor Moloney: I think that part of what we were trying to get at there was that we have 12 SIs, which have 2% of the equity market. Given the huge amount of heat and light generated in the early 2000s, it seems strange to have this huge regulatory architecture. One of the reasons for that is that there is a lot of SI activity in practice, but the way that the legislation has been cast means that it is possible for the industry to manoeuvre around it—we are effectively doing SI activity but the way that the definition is cast means that we can fall out of it.[1] I am not sure that that is the case, but our issue was about how the legislation is drafted.

For example, one of the features of the SI definition is that the system is non-discretionary. In other words, when the SI takes my share order and puts it against its basket of shares, the exchange happens completely neutrally. From reading around the area, one sees in the industry documents and so on that some systems like that might say, "We are not SIs, even though we have a neutral system. Because we as a broker make the decision that we are going to trade with you in this system rather than go to the London Stock Exchange, we are not non-discretionary". I am not sure what the answer is, but there are certain fluidities around the definition.

Other issues one might raise with the SI definition would be, for example, whether you are really quoting to the public enough. The obligation on a systematic internaliser is to act in some ways like a major exchange and to quote to the market, "We will trade with you on all these shares on X, Y, Z prices". Again, the legislation gives the SIs a lot of discretion. You must quote up to £7,500; over £7,500, you do not necessarily have to quote for that order size, yet it does not say how small you must go. Must you quote for £200, £500 or £1,000? The legislation is unclear on that.

This allows some SIs to effectively do SI trading in the dark a little bit. I think that there are perhaps some weaknesses in the directive, but I definitely say here that I do not have a strong view that SI trading should be lit and treated like an exchange. The SI system was absolutely a product of the politics of the time. It was a late change to the directive, and we ended up with a very complicated regime. Indeed, CESR—now ESMA—made the point at the time, suggesting that it did not have a view on whether 12 is too small or too big. It did not want to configure the market so that more SIs were registered. If you are going to put a legislative system in place, it should be clear.

Q37 Lord Vallance of Tummel: On a general point, do you think that it is possibly axiomatic that, the more complex the regulations, the greater the opportunity for gaming?

Professor Moloney: I think so. The reason I say that is because clear rules with strong enforcement act as a deterrent, particularly in the post-crisis world. On the other hand, if you have seven, eight or nine categories of rule, it is not illegitimate but it is a natural market response to think, "Oh well, if we fit into group 7 rather than group 6 then we can avoid something". If you go for a more complex system, you are actually creating quite reasonable incentives to work around the legislation, whereas if you have two—in the system or out of the system—and you enforce that heavily, you create a different atmosphere.

The Chairman: Professor Avgouleas, would you like to answer the question about systematic internalisers or the second point about gaming?

Professor Avgouleas: I think that I have already made the point that the draft directive overelaborates when it comes to classification of trading venues. The definition of systematic internalisers in the first directive was not that successful and the more layers or rules you create, the more opportunities there are for pretty legitimate regulatory arbitrage. I really

[1] The witness adds: The point being made in this paragraph is that the complexity of the SI regime may mean that SI-like activity may not be captured within the MiFID regime.

think that the issue of systematic internalisers and organised trading facilities should be revisited and perhaps the two functions be merged, subject to a strong set of best execution rules.

Q38 Viscount Brookeborough: There are two sides as far as this is concerned: the SIs and the remainder of the market. Do the SIs co-operate at all? Do they play together? They obviously like the business that they are in, but it would appear that they are slightly under attack at the moment. What is their response, apart from that they wish to continue as they are?

Professor Moloney: I do not have a good sense of that. Certainly, from looking through responses to the different consultations, they seem to be working with the legislative process. I have not seen very strong reaction against the type of rules that are coming through. In many respects, I suppose that the more venues that come 'into the light' in terms of the new regulatory system, the less difficulties that the SIs are in. Everybody is increasingly subject to a tougher regulatory environment. I suppose that that kind of direction of travel means that the burden that they are under would be less after MiFID II, whereas at the moment they are very much out there as the bit of the broker-dealer market that is subject to very specific rules. I do not have a sense as to what extent they are working together.

Q39 Viscount Brookeborough: Can I ask one more, quick question? If you create venues and it becomes more complicated, is there not an issue that the public are not really aware where they are trading from?

Professor Moloney: Yes.

The Chairman: Professor Avgouleas, would you care to answer that?

Professor Avgouleas: Yes, that is absolutely the case. For that reason, perhaps it is better to let systematic internalisers and broker crossing systems do what they have always done in picking up the slack from on-exchange trading, and focus more on the issue of lit versus dark trading, where there is a lot of confusion. I am not sure that the way the directive goes, trying to impose blanket pre-trade and post-trade transparency rules for dissimilar markets, is the way forward. There has been, perhaps because of industry pressure, too much focus and attention on what brokers do internally rather than on trying to identify a set of organisation rules that would not change market models but would enhance market efficiency. Of course, enhancing market efficiency here means better prices, which is what concerns investors, because obviously higher liquidity levels lead to better prices and tighter bid-ask spreads. I am not sure whether market-efficiency considerations have been given the thought that they merit in building the new regime and its transparency rules.

The Chairman: Lord Hamilton, you are interested in this point.

Lord Hamilton of Epsom: Which question do you want me to ask?

The Chairman: On pre and post-trade transparency.

Q40 Lord Hamilton of Epsom: I have always had a problem with pre- trade transparency. I do not quite understand how this can work. At the end of day, somebody gives you a price for something in advance of the deal. That cannot last for very long if you are in a very volatile market. Explain to me how this can happen. I understand post-trade transparency but I do not understand pre-trade transparency.

Professor Moloney: Pre-trade transparency is all about the direction of trading. It is sort of telling you how the market is thinking on a very quick, volatile basis. Essentially, post-trade transparency is useful historically to tell you what was happening, but if I am in the market and want to buy shares, I really want to know what people are prepared to sell at. It is really that notion of sentiment and, if I am in the market now, who is prepared to buy and sell at what price. That is hugely informative. What you trade at ultimately and your decision to trade is completely based on the feeling of the market coming in, in terms of pre trade. I suppose that the reason that that it is so important is that, when you tell the market you are about to trade, that is extraordinarily valuable information. You are putting yourself out there saying, "I will do this at X price". That is why you get these huge sensitivities. To go back to Viscount Brookeborough's question, there are so many venues and so many investors, it is absolutely impossible to track the direction of trading. It is absolutely critical that the efficiency of the market is working, that all this pre-trade information is feeding in correctly, that the mechanisms are working properly and, in particular, that we enforce very strongly if the broker is not directing your order to the correct place. For the broker to do that job properly, he needs this flow of information coming through in terms of what prices are doing and where the best venue is for those prices.

Professor Avgouleas: There are two big issues associated with pre-trade transparency. First, if you have complete pre-trade transparency, does that affect liquidity? I think that I have sent you a paper that I wrote with a colleague—the paper tried to measure not liquidity but trading volume, which is a different thing—and the conclusion of that paper is that transparency is not really the determining factor when it comes to trading volume. However, I am really concerned that if we go for the same levels of pre-trade transparency that we have in the stock market in the bond markets, and even the derivatives markets, where some of them are shallow or narrow markets, there could be an issue that we drive liquidity out of European markets. Pre-trade transparency is good for markets that are already liquid but perhaps it is not the best way to go for markets, especially in structured financial instruments or derivatives where the markets are not very liquid.

The second major problem with pre-trade transparency is that traders quote or bid on a price that is based on research that they have done, money that they have spent and experts whom they have employed to do analysis. So their quotes or bid/ask prices tell market participants what is the best price estimates to bid at or ask for a given financial instrument. That cost is something that traders have incurred in order to bid or ask at the best price. If that information, which is going to become evident the second they give the bid or ask price, is widely disseminated, everybody can free-ride on the cost that other traders have incurred, so those traders might seriously consider moving to a different market. Again, I repeat that these are theoretical as much as practical issues. However, empirical research has not given conclusive evidence regarding the liquidity versus transparency trade-off. As a result, the discussion is ongoing.

Q41 Lord Kerr of Kinlochard: It sounds as if the MiFID philosophy is that transparency is always good—there is no discussion of whether there is a trade-off between transparency and liquidity. It also sounds as if the MiFID philosophy is that as much as possible should be brought into organised markets. We are to have this new category of the OTF, which Professor Moloney rather delightfully describes as "an unhappy muddle of organized venue/multilateral trading and bilateral trading concepts". This is a sort of moral issue about as much as possible being brought into the open, is it not? Is your complaint really about the definition or about the underlying philosophy?

Professor Moloney: That is a fascinating point. I think that my issue comes down to the concern that, in some respects, MiFID II seems to be moving away from the big debate, which is—this is something that Professor John Kay is looking at in his Review—whether financial markets, and in particular equity markets, are doing a good job in moving capital from companies through to investors and vice versa. That is really what this is all about. Now, transparency is part of that process, because the more transparent markets are the better the price-formation process. However, that depends on the quality of the information. In my view, the informative type of pre-trade transparency that we have discussed is neutral—"Here is what I want to buy", "Here is what I want to sell" and that all feeds into an exchange that produces a price. That is neutral and disinterested, in that nobody is interfering with these orders, which can move around together. Hence, under MiFID I, those types of neutral multilateral exchanges that facilitate orders coming together could feed into the price-formation process. I think that is right. However, MiFID seems now to have taken the view that everything should be transparent, but it seems to have forgotten what should be transparent, given that there are costs to all of this.

The particular issue that I have is that, as Lord Kerr has just mentioned, MiFID is bringing in all these organised venues. Now, sure, organised venues look a little bit like exchanges, but the key difference is that they are discretionary: in other words, when the order is coming in, the platform is intervening with those orders, so what is disclosed to the market in the end, with respect to pre trade, is not exactly the market view but the platform taking a view on whether to trade with this but not with that. So, yes, you are getting transparency, but are you getting a disinterested market view at a particular time? You might be, but that is not necessarily the case. The issue that I have about bringing in these discretionary OTFs that are half way between a broker and an exchange is that you are not getting that completely neutral mix of third-party orders coming into the market. On a philosophical level, yes there will be a lot more transparency, but in terms of the purpose of the financial markets are we really getting better, more efficient markets?

Q42 Lord Kerr of Kinlochard: If we look ahead five years, assuming that MiFID II comes in as currently drafted—which is a pretty wild assumption, given all the amendments in the Parliament; like you I think that one should take time to get these things absolutely right—how far would the public markets have changed as a result? Would such a change be justified by requirements for financial stability or transparency, if transparency is considered a moral good?

The Chairman: Perhaps Professor Avgouleas would like to answer that and possibly respond to the previous question as well.

Professor Avgouleas: Regulation will always lag behind market developments. We cannot really predict what public markets will look like five years ahead. As I remember, in the late 1990s everyone was talking about alternative trading systems—proprietary trading systems, as they were then called—but, with technology and high capitalisation, investment banks then achieved the capacity to internalise investor orders instead of routing them to an exchange. What is going to happen now with broker-crossing systems? I do not think that we can predict whether MiFID will be fit for purpose five years down the line, because markets will change again and clever people will find more ways to trade more efficiently, with lower margins and at a profit. The proof of this assertion is high-frequency trading.

Another dark point in MiFID is that it does not understand what high-frequency trading is. High-frequency trading is a very clever trading strategy based on algorithms that tries to make the most out of network capacity and speed of communication while capturing market-wide movements. As a result, the order book has become fragmented because big orders are sliced down into smaller orders, whose aim is to enter the system and be executed as fast as possible. This would not have been possible five years ago, because orders can now enter the system and be executed in nanoseconds—not even microseconds—whereas technology five years ago would have meant that order execution took a few seconds. Unless the regulator or the EU Commission or the Governments of the member states take the view that too much innovation in the marketplace is not a good thing and has to stop somewhere—obviously, that would be a rather controversial view to take—we will still be playing a game of catch-up when MiFID is implemented. By then, the issue will not be high-frequency trading or dark pools but perhaps hybrid financial instruments, such as options that turn into stocks or bonds, which no one will have a clue how to regulate. It is much better to build a system on general principles that requires participants' interests to be respected and provides a set of rules in order to protect investors and that requires markets to be transparent and efficient, rather than to regulate the micro-structure of the market.

Professor Moloney: I think that the lesson from MiFID I is that whatever the market looks like in five years' time will not be what people thought in drafting MiFID II. When MiFID I was introduced, everyone thought that the big issue would be the growth of the SI, whereas in fact we had an utter explosion in multilateral trading facilities, which really was not discussed at the time. Whatever happens, it will probably not be what people think under MiFID II.

My strong view is that we need to look at the buy side of the market—the pension funds, insurance companies and mutual funds—which increasingly operates in a highly volatile world, given for example the current eurozone crisis and the introduction of more and more innovative products. We have stability issues in terms of managing long-term portfolios. My concern is that MiFID II should not do anything to make life more difficult for the big, long-term buy investors to make decent returns. Will MiFID II have an impact on that? Probably not, but my concern is that, if there is a slight feel in the directive—which, in my opinion, is the case—that there should be more and more transparency and that things should be pushed more into the regulated sphere, that might make life a bit more difficult for the pension funds, which need to go under the radar for completely legitimate reasons. Will that make the dark OTC markets "bad", if you like, when they are actually extremely important for long-term investors, who need to protect themselves against very significant market volatility?

Now, I do not think that there is a smoking time bomb in MiFID II—there is nothing that is a serious problem—but I have some concerns about the organised trading facility proposals. In particular, I have concerns about the decision that anyone running an OTF cannot trade in it with their own capital, which is very often a way of bringing stability. I think that could be a problem.

The Chairman: Mention of HFT brings us to Lord Jordan's question.

Q43 Lord Jordan: How would you assess MiFID II's proposals on algorithmic and high-frequency trading? What is the purpose of high-frequency trading? Let me also ask the question that many have asked: do you agree with the view that the increased use of automated trading might threaten the orderly functioning of markets in certain circumstances, for instance where algorithms overreact to market events?

Professor Moloney: I think that the MiFID II response to high-frequency trading and algorithmic trading is a good one. High-frequency trading is extraordinarily controversial and is currently being looked at in many fora worldwide, including the SEC in the US, IOSCO—the International Organization of Securities Commissions—and ESMA, which is the supervisory authority for Europe. It is currently an extremely live issue, which a lot of different authorities are looking at.

A key point is that there is a difference between algorithmic trading and high-frequency trading. Algorithmic trading is simply about computer programs trading; high-frequency trading is this extraordinarily speedy, high-volume trading. High-frequency trading is forming part of the financial stability debate rather than the market efficiency debate, but it is very unclear whether high-frequency trading is a good or a bad thing. Certainly as an academic, you can pile up studies on either side that say either that high-frequency trading brings liquidity, produces better trading and provides better price formation or, on the other side, that it causes a lot of difficulties. Given that situation, I think that legislation has to be terribly careful if it is not to create difficulties for something that could actually be useful in certain circumstances. In that respect, I think that what MiFID II does is pretty reasonable. For example, we will have rules requiring major trading markets to have resilient system controls and to be able to shut down an exchange if necessary. Those are absolutely reasonable and they reflect a lot of what is happening internationally.

The one set of rules that I think are a bit problematic are the rules that will apply not to exchanges but to the high-frequency traders themselves, under Article 17 of MiFID II. The particular difficulty here is that MiFID II says that, if you are an algorithmic trader—not necessarily a high-frequency trader but simply someone who is using a computer program—you have an obligation both to trade continuously during the day and to operate on both sides of the market, which means that you need to be buying as well as selling. That is problematic for all sorts of reasons. For a start, algorithmic programs are used by all sorts of long-term buy-side investors and are a completely normal part of the market. Very often and for a very good reason, such investors will go in in the morning, they will go in at the close of the day and they will go in when there is a major market announcement—it just makes sense—but they do not operate continuously. This requirement really does not make a huge amount of sense.

The second thing is that the obligation to operate on both sides of the market means that you are a market maker—you are standing in the middle of the market saying, "I will buy" and "I will sell". However, when regulation wants you to operate as a market maker, which is very risky, it provides incentives to do so and may require you to have certain levels of capital. You are treated quite differently as a matter of regulation. I do not think that that should be expected of high-frequency traders. The obligation to operate on both sides of the market seems an overkill reaction. Most of MiFID II is about systems and information and resilience, which makes sense, but we really do not yet have a handle on whether these very specific rules would be good or bad, so those could be quite a mistake in the future.

Professor Avgouleas: First, let us try to understand what algorithmic trading does. The algorithm monitors market conditions across different markets using a highly sophisticated software programme that mixes passive and active trading strategies, but mostly—not always, but mostly—it is a reactionary mode of trading that is trying to capture market movements. As a matter of fact, research suggests that algorithmic trading captures prices more accurately than human trading. If that is the case, algorithmic trading increases, rather than decreases, market efficiency. As a result, because algorithmic trading is very widely used, there should not be any problem with algorithmic trading.

High-frequency trading is a different story, because it is like a "financial arms race"—all arms races are dangerous. I think that lots of the requirements that MiFID seeks to impose on high-frequency traders are reasonable and plausible apart from the requirement to quote prices on a continuous basis. High-frequency trading does not cause but can exacerbate market dysfunctionalities. As a result, especially in a bear market, high-frequency trading can lead to very fast crashes that cannot be captured by the systems that exchanges currently operate. However, if in future exchanges build a technologically highly sophisticated circuit-breaker which capture flash crashes and stops them without leaving trades unsettled—orders might be allowed to amass in the system, but trades should not be left unsettled because that would create a systemic risk—high-frequency trading will become much less of a problem. Countering high-frequency trading is much more an issue of technology than of regulation. Simply, markets need to put in place circuit-breakers that will be highly sophisticated and operate in nanoseconds in the same way that high-frequency trades operate. If that happens, there will not be the need to regulate this form of trading too much.

However, another problem with high-frequency trading, which I would controversially suggest is much more important than flash crashes—which, as I said, can be captured and stopped if the right technology is put in place—is that it slices orders. Buy-side investors such as pension funds and other institutional investors often need to conclude a very big trade, but with high-frequency trading this has become ever more difficult. As a result, I do not really understand how the increased pre-trade and post-trade transparency provisions in MiFID would help buy-side investors, who are already suffering because of the way in which high-frequency trading slices orders, which makes the conclusion of big trades ever more difficult.

Q44 Lord Jordan: Both of you seem to have given algorithmic trading a clean bill of health, and the villain of the piece seems to be the high-frequency trading. Are you saying quite specifically that algorithms do not overreact to market events and cannot threaten the orderly functioning of markets?

Professor Avgouleas: I'm afraid that is not what I am saying. I just say that algorithms are built in such a way that they do not normally overreact and do not normally cause market crashes. In the exceptional cases where they do so, exchanges should upgrade their technology to make it more sophisticated and, by means of operating sophisticated circuit-breakers, should be able to forestall the flow of orders—not the flow of trades—into the system so as to prevent a crash. That is much more an issue of technology than an issue of regulation. In all those instances where algorithms do not overreact and do not cause crashes, they are a good thing because they contribute to the marketplace's price efficiency as they capture prices better than human systems.

Q45 Lord Kerr of Kinlochard: Presumably, algorithmic trading makes the market more efficient by making it respond more quickly to a trade, and therefore it makes the market more volatile. I must say that I am attracted by Professor Avgouleas's line that you should not try to legislate, particularly in primary legislation, for particular trading methods but instead set market rules. The Professor lays particular stress on consumer protection, but I do not see how the consumer loses out from high-frequency trading; if anything it seems to me that the consumer gains very slightly.

Can I come back to the OTC issue? Clearly, there is a desire to reduce the size of OTC markets. Professor Moloney says, "the OTC markets fulfil important functions in providing additional liquidity, minimizing market impact risk, and supporting investor choice". What should we think? Is it a good idea in principle to try to move more out of OTC markets? Is it legitimate? Will it work?

Professor Moloney: The context for my answer to this is that legislation gets into trouble more quickly if it tries actively to shape what a market looks like and if, instead of just saying that we want efficiency and consumer protection, it starts to provide a much more interventionist style of regulation requiring X number of trading venues and, for example, 25% of trading to be OTC rather than just letting the buy side say that we need capacity in the OTC side. Essentially, the legislation should say, "Okay we will facilitate that, but here are the bottom lines: if you are in the OTC market, we will expect conflict of interest protection, best execution rules and so on". Once legislation moves beyond that, you are into very difficult calls about the relevant size of each segment of the market, which is extraordinarily difficult to call. I think that the market itself—in particular, the buy side or the big long-term investors—is the best judge of how much transparency is a good thing and will by its behaviour drive the size of the OTC market. That is how I would think about that.

As somebody said—I cannot remember who—at some point in the MiFID II negotiations, everybody agrees that transparency is a good thing but not everyone feeds into it. And there are good reasons for not feeding into it. If legislation is beginning to create the sense that everything should be on a platform and suddenly the OTC markets are, if you like, the hedge funds of the financial markets—and we all know that hedge funds do very good things, although they can go wrong—I do not think that we should see the OTC markets as this sort of dark side of the market. I am slightly concerned that there are perhaps elements of that coming through in MiFID II.

Professor Avgouleas: I think that the answer here has to be nuanced. When there is systemic risk and investor protection risk, trading in financial instruments should be moved on exchange. Even mandating strict settlement limits in some cases will not protect us against systemic risk, because a number of those products create very strong interconnectedness between different markets and different segments of the same market. The exposures of and interconnectedness between the great institutions of the world would remain invisible to regulators and we would have results as in the recent crisis. Instruments that are capable of creating strong interconnectedness that can lead to a systemic crisis are better traded on exchange, so that the links of interconnectedness that they create are made visible to the market and to regulators.

However, that does not mean that all kinds of OTC instruments have to be brought on exchange. I do not understand the case for on exchange trading of certain forward contracts. I understand that there are food price index derivatives that might or might not influence global food prices. If empirical evidence shows that they do so, these products should be brought on exchange and traded in a visible way, but I do not understand why a farmer in Kansas cannot sell a forward contract to a cereal company when that ensures that they both get better protection against future market movements and better prices. It escapes me why this product has to move on exchange.

The Chairman: Lord Kerr has a further question on that, but we must then move on, colleagues.

Q46 Lord Kerr of Kinlochard: Let me just pursue that point a little further. Would you say that, given equities at one end of the spectrum and big rather unusual bonds at the other end of the spectrum, the rules of transparency should not be the same all the way across the spectrum? Is that correct?

Professor Avgouleas: Yes, for liquidity reasons, but that does not mean that the instruments should be traded OTC. We can still have on-exchange trading or another form of organised market trading with transparency waivers.

Lord Kerr of Kinlochard: And the criterion would be how often the instrument is traded?

Professor Avgouleas: Yes, in order not to harm liquidity.

Q47 Lord Flight: Can I ask about third-country access and what you think of the Commission's proposals for granting access to EU markets for third-country firms and market operators? Do you think the approval process could be simplified? Just stepping back, I am not really sure whether these proposals bite. If I am a money manager trading in London and want to deal with a market operator in Singapore, I cannot really think that the Commission will stop me or can actually make rules about it. As long as the market operating in Singapore happens to be cheaper or better than the one operating in Frankfurt, then word will get round and people will deal with it. Do these proposals really make any sense?

Professor Avgouleas: As previous witnesses to your Committee have observed, this third-country firm authorisation by means of a branch is, on the face of it, a liberalisation measure but in practice limits the access of third-country firms to "fortress' Europe". Obviously, there is the issue of solicitation, but this is not how things work in global markets. As a result, in practice when it comes to the big institution—the wholesale players—it will not work and it will be rendered impractical. As a result, the way that the US regulates third-country firm access should be looked at more carefully and perhaps imported into Europe.

Having said that, in the case of retail markets, I think that there are investor protection concerns. Recall the issue of the Lehman's mini-bonds and various savings scandals throughout Europe where, by means of a local branch, retail investors buy a sophisticated investment product from a third-country firm and then lose all their money. The seller, who has not advised, is only the intermediary and does not undertake any responsibility so investors lose their money. There are such cases in Italy and Greece. I also heard that there were a few cases in Hong Kong. Obviously, that kind of third-country firm access to the retail investment market has to be regulated, but that is a different thing from shutting down the borders of European markets to third-country providers and especially wholesale service providers.

Professor Moloney: I very much agree with the point about the consumer markets. I think that this idea of having a physical branch is a good part of the legislation. If you want to access the consumer markets in Europe, you must physically have a branch and, as a matter of mandatory harmonisation, you will be subject to the MiFID II rules on conduct of business, conflict of interest and so on. That is a good development.

On the money-market side, the eligible counterparties and the big international markets, there are a couple of issues. There is a political issue. In the wake of the crisis, no regulator wants to be in the position where it does not know what is happening or who was in its back garden. There is the sense now that regulators want to know who is there and what they are dealing with. That is one of the drivers of this: it is registration, of knowing who is there, rather than regulating them. Lord Flight makes an excellent point that, with the huge flows of capital, if Singapore or Hong Kong is a much more attractive market, they will simply move to Hong Kong. I think that what is happening here, though, is that there is a sense that if you want to access Europe's deep liquid market then you will have to register your presence.

Lord Flight: But markets work the other way round.

Professor Moloney: I am slightly sympathetic to where the Commission is coming from here. There is a sense of, "Well, we want to know what is happening". Secondly, on the drivers behind this idea that to be registered by ESMA your system must be broadly equivalent, there is an element of exporting how the EU does things. At the same time, it is a way of trying to put in place internationally certain baseline standards as to how the major wholesale markets behave.

Lord Flight: If it were to impact, you would have to have a rule that says that a dealer or money manager in the EU is not permitted to use a market maker or broker in Singapore or Hong Kong. That would be a protectionist trade war.

Professor Moloney: That is an issue. One of the interesting issues about this is that the new European securities market regulator, ESMA, has been given this notional power to deregister third-country firms if they or their systems do not comply with whatever minimal rules might work. It is very difficult to see how that would actually operate in practice. Part of this is the sense of Europe saying, "We are a major world regulator, we never want a financial crisis again and we want to know what is happening in our markets". That is a lot of what is going on behind it.

The Chairman: Baroness Prosser, your cue.

Q48 Baroness Prosser: I want to ask about ESMA, but first I have a general question. You will be aware of the Commission's proposals to strengthen the role of ESMA. A lot of what you have said leads one to think that that probably makes a lot of sense. Presumably, there needs to be a balance between the European role and the role of nation states. Could both of you say a little about what that balance ought to be and what the issues are around that?

Professor Moloney: One of the key issues about allocating powers centrally in Europe and between the member states is about accountability and fiscal responsibility. When a decision is being made that has fiscal consequences for local taxpayers, I do not think that can be made at a centralised European level. That is a basic issue about democratic and political accountability: if the taxpayer is paying for the consequence of an enforcement decision then that decision has to be held locally. That is one of the big dividing lines.

The second dividing line is a matter of efficiency. Europe is getting a lot better at making rules. There are specialisation and economy-of-scale issues. The financial world is now so complex that there is a lot of efficiency in centralising expertise, communication, consultation and so on. The rule-making capacity—the additional rule-making and implementation powers that ESMA is getting—makes a lot of sense. However, where you are looking at direct supervision, it is simply much more efficient to hold that at local level. Local authorities are much closer to the local markets. It is supervision and enforcement decisions that tend to have the fiscal consequences. Those should be kept at local level.

Specifically, one of the powers that ESMA may be given under MiFID II is with respect to product intervention. ESMA would have the power to temporarily prohibit a product across Europe. That is innovative and experimental, and potentially very useful because ESMA is developing a consumer protection theme to its work. In many respects, one might see where it is difficult for a local regulator to act but the European regulator might be able to do so. Broadly speaking, across MiFID II the kinds of powers ESMA is getting are fairly carefully calibrated. My sense is that those powers are within the spirit of the original regulation back in 2011, or whenever ESMA was set up. It is within that system.

The Chairman: Professor Avgouleas, do you have anything to add to that, although we are a bit short of time?

Professor Avgouleas: I would say three things. First, ESMA will probably be overstretched for resources and rely on other people and especially national regulators.

Secondly, there must be a pan-European consumer product protection agency for financial instruments, not with the power to ban instruments and services but in order to scrutinise them and issue opinions or sanction default choices. I do not know how you can ban an investment service or financial product given the accountability structures under which ESMA currently operates. I understand that there is a need for strong regulation in consumer protection markets. For example, someone should have scrutinised and vetted the sub-prime mortgages, but there is a massive difference between scrutinising an instrument or service and prohibiting one. I am very sceptical about the power given to European regulators to do that.

Thirdly, because of ESMA, we are going to have layers upon layers of European regulation. I do not think that even experts will be on top of things, so European regulation will become more and more expensive for investment firms in Europe, especially for smaller firms. The Commission, ESMA and the European Parliament should think very seriously about tailor-made rule books which cherry-pick rules, provisions, exemptions and waivers from the general legislation. They should put them in comprehensive rule books individually addressed to different classes of investment firms, e.g. asset managers, brokers, investment firms and investment advisers. Otherwise, it will become very expensive for investment firms in Europe to comply with the new regulations.

The Chairman: Professor Avgouleas, I will stop you there so that Baroness Hooper and Viscount Brookeborough can ask their questions. Then I will have a final response from our witnesses if there is anything else that they wish to say.

Q49 Baroness Hooper: Turning to the commodities market, I would be interested to hear your views on the proposals relating to the regulation of commodity derivatives. 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"?

Q50 Viscount Brookeborough: It is a privilege to be grouped with Lady Hooper. This question is on investor protection and corporate governance. How clearly do you think MiFID II will meet the objectives of improving these matters? Secondly, in this country there are perhaps more independent advisers than in other jurisdictions. If this country gold-plates—as it is very used to doing in every sphere of European life—over and above MiFID II, will this in fact disadvantage us?

Professor Moloney: I will defer to Professor Avgouleas on the commodities markets question. Quickly on the investor protection side, I have doubts about some of the corporate governance proposals, such as those that say that you must have a particular gender balance and so on. Not everybody is of this view. I do not think that boards are a forum for different kinds of social outcomes. I am not sure that the different structures with respect to board governance, apart from the focus on better risk management, will necessarily lead to stronger investor protection outcomes.

On the issue of independent advisers, in some respects MiFID II is a missed opportunity here. What has happened under the FSA's Retail Distribution Review and tightening up of the market for independent advice is a good thing for retail investors. What MiFID II has not really grappled with is that the issues that the independent adviser regulation is trying to address in the UK appear in Europe but in a different context—the financial supermarket.

Unfortunately, MiFID II has not addressed the notion that if you are not an independent adviser, which is of course the UK model, but simply a very large, full-service continental bank, an investor still faces significant conflict of interest risks. It is a shame that MiFID II has not really got to grips with that in terms of applying an equivalent model to what is happening in the UK to the sale of proprietary products by financial supermarkets. That is not independent advice as we would recognise it, but nonetheless investors are vulnerable to conflict of interest risks, incentive problems and so on. It is a shame that MiFID II has not picked up on that.

The Chairman: And just a brief reply from Professor Avgouleas.

Professor Avgouleas: As regards commodities markets, things like co-ordinated disclosure and position limits could prove very helpful in deterring or detecting market manipulation. Commodities markets have traditionally not been very proactive in this area because trader interests dominate most of the commodity exchanges. However, the fact that the deterrence and detection of manipulation in those markets will become much easier does not mean that food-price volatility will disappear. There are other more exotic instruments that influence food-price volatility. Above all, food-price volatility is driven by supply and demand. No regulator will ever be able to do anything about a natural catastrophe that destroys a grain harvest in Russia, for example, or do anything about the emergence of BRICS or other developing countries where living standards improve and as a result so do food consumption habits. These changing habits put a premium on food production. Depending on the economic cycle in these countries, there will be more or less demand. As a result, volatility will continue. Even though these provisions are absolutely crucial for the deterrence and detection of manipulation of commodity markets in Europe and globally, I do not think they will do very much about food-price volatility because there are so many other factors at play there.

The Chairman: Colleagues, I will finish it there. My apologies to our witnesses that we have run out of time. As I indicated earlier, if there is anything that you wish to supplement in the evidence you have given us today, please do so. Please look at the transcripts that we will make and correct those when you have the opportunity. I say to the two of you that, on a cold, unflaming day in June, you have brought warmth, light and luminescence to this very difficult subject. In the imperishable words of John Milton, on this subject you have made "darkness visible". I thank you on behalf of the Committee.

Chris Bates, Clifford Chance, Christian Krohn, Association for Financial Markets in Europe and Guy Sears, Investment Management Association (IMA) – Oral evidence (QQ 1-15)

Evidence Session No. 1. *Heard in Public.* *Questions 1 - 15*

TUESDAY 22 MAY 2012

Members present

Lord Harrison (Chairman)
Viscount Brookeborough
Lord Dear
Lord Flight
Lord Hamilton of Epsom
Lord Jordan
Baroness Maddock
Lord Marlesford
Lord Vallance of Tummel

Examination of Witnesses

Chris Bates, Clifford Chance; **Christian Krohn**, Association for Financial Markets in Europe; and **Guy Sears**, Investment Management Association.

Q1 The Chairman: Colleagues, I am very pleased to welcome Guy Sears, Christian Krohn and Chris Bates to our first evidence session on MiFID II. I say to our witnesses that we are being webcast and we will make a transcript of our exchange, which we will send it to you. Please look at the transcript and correct it and, if you have further thoughts—you always have further thoughts after you have walked out the door of a witness session—please communicate them to us. We are very grateful to you and I apologise for the delay. We are very keen to have your information on this tricky subject.

I remind my colleagues that, as this is the first official session on MiFID, any interests that they have should be declared in open session before they speak. With that in mind, I ask the general question first. What is your overall assessment of MiFID II? What are its strengths and weaknesses? Was the review of MiFID necessary? It would be very helpful if you could fit it into the jigsaw of other pieces of EU legislation, such as the market abuse directive, and that on over-the-counter derivatives and short selling?

In each case, when I call you, perhaps you could just introduce yourselves and, if you want, make any general statement, although I think that my opening question probably allows that opportunity.

Chris Bates, Clifford Chance, Christian Krohn, Association for Financial Markets in Europe and Guy Sears, Investment Management Association (IMA) – Oral evidence (QQ 1-15)

Chris Bates: Good morning. My name is Chris Bates. I am a partner at Clifford Chance here in London, where I lead our financial regulation practice. I am also a member of the council of the International Regulatory Strategy Group, which advises the City of London and TheCity UK on regulatory matters and which has commented on aspects related to MiFID.

In response to your question, I think that a review of MiFID was inevitable, because it was required by the directive itself. It was also inevitable because certain aspects of the G20 commitments to regulatory reform following the crisis needed to be implemented in the EU, particularly those relating to trading of OTC derivatives, and the MiFID review proved to be the vehicle for that. The interesting part of MiFID II, in a way, is that it confirms the basic structure of MiFID and does not interfere with it. It is a conservative measure because it leaves the structure broadly intact—with some key developments that we will touch on in this session.

As for general remarks, I just make two points relating to third-country firms, which we will probably come back to later, and to the product banning and product intervention powers. Third-country firms were an area that the original MiFID had left alone and on which member states retained discretion, so we had a patchwork of different approaches. Many people accept that some form of European harmonisation in this area is helpful in creating some minimum framework for the treatment of third-country firms, but there is a feeling that the Commission's proposals are unhelpful because they create two basic regimes for branches and cross-border business that depend on two critical assessments, which few countries are likely to pass. The proposed framework for third-country firms is based on assessments of equivalence and reciprocity. Look at the range of firms doing business in London and throughout the EU through branches—London has about 20 branches of foreign banks, some of them very significant, from a very diverse range of countries. More importantly, on the cross-border side, firms in London do business with counterparties and service providers around the world in dozens of countries. The chances of all those countries, or even a significant number of them, passing the equivalence and reciprocity framework that the Commission has proposed are slim.

So those apparently liberalising proposals are significantly less liberalising than they look. Particularly for the UK, with its international focus, this is a very serious concern. Effectively, we would be saying to the rest of the world, "Don't call us; we'll call you". The Commission's second regime is effectively a solicitation-based regime, which is completely different for wholesale business from that which exists in the UK and a number of other key jurisdictions. This is an area of critical importance to firms in London, because if they cannot do business with you, you cannot do business with them. That is the basic message. The UK and other financial centres in Europe are critically dependent on their ability to do business cross-border.

The Chairman: I think that Lord Dear will take up that point later, but you had a second point.

Chris Bates: Yes. I think that that area has had a significant amount of attention, which is helpful. The other area, which has possibly had less attention, is the product intervention powers in the proposal. These are interesting, because they give a very broad regulatory, almost legislative, power to national regulators and ESMA. Essentially, they give them the power to ban or restrict—in other words, to regulate—any distribution of financial instruments and, indeed, any financial practice, apparently, by anybody. That is a much broader power than is given—

Viscount Brookeborough: On what grounds?

Chris Bates: On the grounds of significant detriment to investor protection or serious impact on financial stability. Those are the core grounds for regulation. That has a serious and largely unexplored impact.

The Chairman: Let us get Mr Krohn and Mr Sears into play.

Christian Krohn: Thank you very much for this invitation to give evidence on the European Commission's proposal on the MiFID directive. It is a pleasure to be here today. My name is Christian Krohn and I am here on behalf of the Association for Financial Markets in Europe. AFME is the voice of European wholesale financial markets. We represent leading global and European banks and other significant capital market players. We advocate stable, competitive, sustainable European financial markets that support economic growth.

AFME is engaged in almost every issue affecting Europe's wholesale financial markets, but MiFID is one of the most far-reaching and important reform proposals made in Europe since the financial crisis began. It has now been about six or seven months since the draft MiFID texts—the MiFID and MiFIR proposals—came from the Commission, and we are at a critical stage in the political debate, so the timing of today's session is ideal. We welcome the MiFID review and in principle support much of what the Commission is seeking to achieve. However, many of the proposals to implement those policy objectives will require recalibration to avoid, or at least to mitigate, collateral damage to market liquidity and investor choice.

While the list of indicative questions that I was kindly sent in advance of this session cover many of the main issues, some other issues arise that I would like quickly to cover. I should like to remark on the Commission's proposals regarding open access to market infrastructures. Some infrastructure business models require that their users trade, clear and settle transactions on specific platforms owned by that single group. In our view, this removes the incentive for quality and efficiency of service to be improved through competition. Therefore, AFME strongly supports the proposed requirement for trading venues to provide equal access to central counterparties that are not tied to that trading venue, and vice versa. I also mention briefly the European Commission's proposals regarding pre-trade transparency for non-equity trading venues. We support the Commission's transparency agenda but are concerned that the transparency requirements in that regime may not be appropriate to the request-for-quote model of trading that is common in non-equity markets. Finally, I briefly mention the European Commission's proposals for post-trade transparency for non-equities, where we welcome very much the Commission's proposal to require the industry to publish post-trade information on non-equity trades in as close to real time as possible, but we stress that the permitted delay should include as a criteria the liquidity profile of the instruments concerned.

That concludes my opening remarks, but I was also asked to opine on the general necessity of the MiFID review. I agree completely with my colleague, Chris Bates, that there was an air of inevitability about the review. In AFME's view, most of the major objectives of MiFID I were achieved in increasing competition and strengthening investor protection, but sub-optimalities emerged, not least increased fragmentation of data relating to trading. In addition, the financial crisis brought on to the table new objectives for MiFID, not least financial stability, which has already been mentioned.

In short, we think that the review is necessary. Our overall assessment is that we agree with many of the Commission's objectives about strengthening investor protection and injecting more competition and efficiency into European capital markets. Our concerns relate to the ways in which the Commission is trying to achieve those policy objectives. Examples include the Commission's proposals on organised trading facilities—which I know we will cover—where we think that the proposed ban on the deployment of own capital within the organised trading facility renders that regime more or less unworkable. In the pre-trade transparency context, we think that the proposed requirements for pre-trade transparency and firm quoting—making the same quotes available to other clients and making certain quotes available publicly—are extremely problematic and, if they carry on as currently drafted, will lead to a negative impact on market liquidity and investor choice. We also have concerns about the algo and HFT proposals, which I know we will discuss further today, and similar concerns to those already expressed about third countries.

The Chairman: That is really very helpful. Let us give Mr Sears a start.

Guy Sears: Thank you. I am director of wholesale at the Investment Management Association. Although normally we might be associated with funds, about £1 in every seven is run in authorised funds. This is the second biggest asset management industry on the globe. We run about £4 trillion sterling in money for other clients. It is larger than the world's hedge fund industry put together, so we have a very keen interest in MiFID. Most of our firms are MiFID firms, some obviously are UCITS firms.

Yes, the review was necessary. The more interesting question is: why now? It was certainly unfortunate that there was a G20 commitment on MiFID—the requirement to provide that derivatives could be traded on exchange. Almost certainly, that advanced the MiFID review and made people feel that they had to get on with it. If that had not happened, there was great hope that they would have taken more time and reviewed it later. The timing was unfortunate.

In terms of our overall assessment, clearly there was a completion of unfinished business. The sheer political investment to break up the national domination of exchanges—to require greater fragmentation among trading venues—meant that a lot of the impact work was not done at the time: as Christian Krohn said, there was not sufficient consideration of how data consolidation would occur; there was not sufficient consideration of how to co-ordinate short-selling bans; and there was not sufficient consideration of how to deal with suspension of trading in this fragmented, pan-European environment. From that point of view, there was some completion of unfinished business. There was also a need to extend investor protection way beyond just the MiFID instruments into the wider range of economically substitutable retail products that investors use, whether structured products or insurance based. That is the packaged retail investment products review that MiFID is part of and that we are still hoping to see the other parts of.

On the other side, in terms of the assessment, there is a real risk that it will close down competition. I hesitate to say that the sky will fall in on our heads—I think that the City is well versed in repeating that mantra and it does not always occur; in fact we are sometimes the cause. Will the sky fall in on our heads? Who knows? The third-country provisions are unworkable for us, and we will address that. We would also like to address the provisions to impose a market structure on fixed-income markets in pre-trade transparency. It seems to us that, if there is one thing that needs to be done beyond dealing with the pension issues and the savings overhang across Europe, it is ensuring that the debt markets operate efficiently in the next five to 10 years. I suggest, in the words of "Yes, Minister", that it is pretty bold to be restructuring those markets at the moment

The Chairman: I thought the word was "challenging", but it may be "bold".

Guy Sears: I would not disagree with you, my Lord.

The Chairman: That was a helpful tour d'horizon from the three of you.

Q2 Viscount Brookeborough: The Committee will also be scrutinising the Commission's market abuse regulation proposals. What is your view of those proposals? Do they go far enough and will they be effective?

Guy Sears: I gave evidence before ECON a month or so ago on the proposals. The proposals include a provision that seeks to impose across Europe the RINGA provisions, the super-equivalent regime that we have in the United Kingdom and which the IMA has always fought to retain. Our position is that, as proposed, such a provision would not work and we would prefer it to be dropped if it is not amended, even though that would mean that we would lose it for the United Kingdom as a type of market abuse protection. There is work going on to try to get that working.

Also, I think that people probably got a bit tired of writing out everything and they left out bits from the existing market abuse directive that address the important need to ensure that there is both research and, more important, engagement with businesses. There are various provisions under which firms will have responsibilities of stewardship and engagement. Our concern is that the provisions do not sufficiently recognise their interest in asking questions and while still being able to deal on the other side of the house. We think that there is an understanding among both the Council and the Parliament of our concerns, but as ever we will need to see how that comes out in the wash.

The Chairman: Mr Krohn and Mr Bates, would you like to answer that?

Christian Krohn: We certainly support the proposals to make intentional market abuse a criminal offence. We support the extension of the market abuse requirements beyond regulated markets to other venues, multinational trading facilities and organised training facilities as well as OTC. We see the application of the RINGA concept as problematic. We think that moving away from the accepted definition of insider trading embodies all sorts of issues, not least in the context of the pre-sounding meetings between issuers and their prospective debt holders or shareholders. We think that the RINGA concept as currently proposed in the directive will lead to a reduction in such meetings and a consequent reduction in the availability of capital.

Q3 Viscount Brookeborough: Do you think that those views are shared by other market centres in Europe?

Christian Krohn: I would have to go back to the colleague who is the expert on this to see to what extent we have liaised with colleagues on the continent.

Chris Bates: I think that there is particular concern about the RINGA issue among people in continental Europe because, first, they have never seen it before—it is a peculiarity of the UK regime. The proposal has caused concern for precisely the same reason that it causes concern here, in that the breadth of it creates barriers to interactions between investors and managers.

I might mention a couple of other things. On the treatment of commodities and non-standard securities markets, once you extend market abuse concepts outside the area where issuers have obligations to announce and keep the markets informed, it is very difficult to apply the same standards. IOSCO and others have recognised that for many years. People who participate in the commodities market inevitably have differential information, so you cannot just say that possessing any material information that is not public prevents people from trading. That is a core issue, which even the revisions in process have not yet addressed.

On the criminal side, there has also been a lot of focus to date on trying to improve the text of the directive on the administrative or civil regime, but there has been less attention to date on how to make the criminal regime work. The proposal for the criminal regime raises some significant concerns. In terms of scope, the criminal regime needs to be in line with the directive regime, but at the moment it is broader, so you would have the oddity that actions could be criminal that were not capable of falling within the civil regime. A lot of the defences and gateways that have been put into the civil regime would not be reflected in the criminal regime. I think that the criminal regime needs more work and needs to leverage more from the civil regime to make it clear that what we are trying to do in the criminal regime is to identify conduct that would be within the scope of, and sanctionable under, the civil regime but is exceptionally serious because of the intentionality and knowledge. That clearly needs further work.

Guy Sears: Just quickly on what others in Europe think, one hesitates slightly to say this from the UK perspective but there are 27 member states whose elected members are negotiating this. I doubt that a handful of those countries have the sophistication of the financial market interactions that really expose the difficulties at the edges of this legislation.

Q4 Lord Hamilton of Epsom: Continuing with the questions out of order, I want to ask about investor protection and corporate governance. AFME argues in favour of "investor protection, appropriately addressing institutional and retail needs". To what extent does MiFID II meet this objective?

Christian Krohn: When we say that, we focus on appropriateness. In MiFID I, we see a client categorisation regime that we think, on the whole, has worked very well, as the Commission has indicated. Appended to that client characterisation regime—retail on one side, professional or wholesale clients on the other—are appropriate levels of protection. We think that the regime as set out in MiFID I more or less worked, and if it ain't broke, we do not think that we should be trying to fix it. We are concerned that, in its eagerness to extend maximum protection to retail investors—which is all well and good—the Commission risks imposing undue burdens on wholesale market participants.

Q5 Lord Hamilton of Epsom: Mr Sears, can you explain why you believe that the ban on inducements applying only to independent advisers will have perverse consequences? Can you elaborate on your assertion that there should be proportionate application in the area of corporate governance?

Guy Sears: On the ban on inducements, there is not a terribly deep analysis. There is a proposal that independent advisers could not receive inducements, but the proposal is silent on the others. On the assumption that the level 2 measures that we have under MiFID I are retained or replicated, the receipt of inducements by others would apply where it does not distort one's duties to the client and give rise to bad advice. Given that there is no definition of independent, if there is a huge cost to being independent, people will just do whatever is necessary to describe themselves as not independent. This is just a very clumsy, cliff-edge rule. If it was expressed, as under the rapporteur's proposals, as a better expression on disclosure or if it went to where the FSA is—with a ban without regard to whether you are notionally, in your own categorisation, independent or not—so that we had a level playing field, we would not have an issue. We are just raising the issue that, if you have a very clumsy self-certifying mechanism that says, “I hereby sign a piece of paper that means that I cannot get an inducement”, people are not going to sign it.

Corporate governance is imposed on our firms by MiFID and by the capital requirements directive—we are caught by the width of the capital requirements directive under the Basel III provisions. Proportionate application does not at all take away from the need to ensure that firms are well governed. However, the issue is expressions that say that nomination committees should exist, when there may be only three people running the firm. There are also expressions on diversity and openness, which are absolutely laudable, but if two of you are running the firm, what is the appropriate application of that? The issue particularly comes up with the requirement to have non-executives. Any partnership structure has only executives and many firms only have executives. It seems to us that, as the Danish presidency has proposed, as long as that is seen as an expression not of one having to change the business model to fit it but is applied proportionately to other business models, we have no concern. The issue is not the standard, but the fact that this is potentially a regulation, which will therefore look like hard-edged requirements.

Q6 Lord Vallance of Tummel: Would that not be covered if the comply or explain principle were brought into this?

Guy Sears: “Comply or explain” is an expression of what listed companies have on governance and is very effective there. “Comply or explain” for us is how we explain ourselves to our regulator, which is the FSA. From that point of view, as long as there is always the facility for national regulators to allow firms to structure their governance in a way that the regulator thinks still meets the obligations and firms can justify it to the regulator, absolutely yes.

Chris Bates: However, I think that the model proposed in the text is not like that. The model proposed is a regulatory model based on a listed company model without “comply or explain” applied to a huge diversity of firms, from very large firms to two-man bands.

Lord Vallance of Tummel: But the principle would be worth while going for, if you like.

Chris Bates: Yes, I think that we should move away from that very prescriptive model, which focuses on the duties. It seems to me that the model that is being looked at, with the issues of diversity and nomination committees, is more attuned to listed companies rather than private companies and small businesses, which many of these firms are.

Christian Krohn: I completely support those comments. From AFME’s perspective, many of the proposals seem excessive. Those include: the determination on the number of directorships that any one individual can hold; the determination that the nomination committee be comprised exclusively of non-executives; and the determination that the potential liability of non-executives must be exactly the same as that of executives, which does not recognise the difference between those two groups in terms of the time spent and their ability to give direction to the investment firm in question.

The Chairman: It is all rather too mechanistic.

Christian Krohn: Yes.

Q7 Lord Flight: I want to ask about transparency. First, what do you think of the new category of organised trading facility? Is that necessary? What is it really all about? How do you think that the proposal to prohibit operators trading against their own proprietary capital will operate? More widely, you have effectively made the point that London is the key wholesale market and that the complicated bits of MiFID are about the wholesale market.

Are the relevant people within the EU seeking and taking on board appropriate advice vis-à-vis the London market?

On the Commission's proposals on trade transparency, should a distinction be made between pre and post-trade transparency? What are the precise implications of that? Perhaps Guy Sears could say on what grounds he believes that the proposals for pre-trade could harm investor interests, for example by reducing liquidity. Perhaps Christian Krohn could elaborate on his concern that the proposed regime is not appropriately calibrated for non-equity markets.

Christian Krohn: I think that I can remember most of those points. First, on the organised trading facility regime proposed by the European Commission to sit alongside the existing venues of regulated markets and MTFs, in principle AFME is supportive of the new OTF category on the basis that a platform that brings together third-party buying and selling interests on an organised basis should be subject to consistent regulation. By and large, we think that the regime proposed by the European Commission works, in that it gives the non-equity and equity markets the scope that they need to conduct the sort of trading that is not appropriate to be conducted through a regulated market or a multilateral trading facility.

Our fundamental concern with the organised trading facility regime relates to the proposed ban on the operator of the OTF deploying own capital within the OTF to facilitate client trading. We think that that is extremely problematic. In all but a very few instances where there is exact matching of buying and selling orders, orders will not be filled—at least not immediately. There will be an extended period when they are not filled, to the detriment of liquidity and investor choice. Therefore, we advocate that the proposed ban be removed. Recognising what the Commission is trying to achieve through the ban—to ensure the neutrality of the OTF operator—we propose that the conflicts-of-interest rules and client-order handling rules in MiFID be clarified and applied to the OTF operator. Also, married to that, we propose a client choice regime whereby the client of an OTF pre-emptively chooses whether his orders should interact with the capital of the OTF operator.

Guy Sears: There were two drivers behind the need to create a category. The first were the dark pools and squabbles that go on in Europe over whether or not business is being taken away from regulated markets and all the fight that went on. Clearly, for the buy side, the venues are a cost of doing business, not a profit centre. The second driver was the requirement under the G20 to have organised places for derivatives to be traded on exchange or the SEFs in the United States. Those two drivers came together to give a common definition that, conveniently, could be used across all markets. The difficulty with definitions like that is that, until you get to the detailed calibration underneath, they do not really tell you anything; all they tell you is that someone has power to make rules.

From that point of view, the proposal is understandable. As Christian Krohn said, in particular areas, we think that it is appropriate to have market regulation applied to certain activities—the dark pools—mainly because, we hope, it will end the needless squabble so that we can get on with business. In terms of the other areas and how it will work in the fixed-income market where there is no existing business equivalent of an OTF, we are not sure what is intended. As ever, there is a huge amount of detail to be dealt with at level II—it is left to delegated acts and to the Commission on its own—and that is a concern. It is also a concern because it might blight innovation and investment for some years. If we have to wait two years to know what is to be allowed and not allowed in business, why on earth would you apply your capital there at this time?

We would not have asked for the ban on prop capital. Buy-side traders want to know with whom they will be interacting. They want to be able to choose whether they are working with high-frequency traders, the open retail market or other large buy-side traders in block trading. That choice—and the fact that some of those venues are run by Christian Krohn's members—and the facility to choose where to trade is why they are attractive. If we shut it down and say "No prop capital" and end up with a single model, let us hope that that model is the most efficient, because we will have put all our eggs in one basket. We would like a diversity of competing models. Perhaps sometimes we should leave it a few years to see what works well. From that point of view, it is not attractive that prop capital is banned. It would be much more sophisticated if we just had a regime that allowed appropriate transparency tools and regulation of any of those business models and we allowed disruptive competition to occur that would, we hope, lower costs and improve the quality of service that everybody gets.

Chris Bates: One issue that has arisen with respect to the OTF definition is the "one governor, two masters" problem—it is a definition trying to do two jobs at the same time and probably ending up not doing either of them particularly well. What we end up with, as Guy Sears has said, is the power to make rules that define what is permissible for trading of OTC derivatives. That is a much clearer goal. In the other area, we end up with a big debate about the boundary between organised trading and OTC trading, with the intention being always to squeeze OTC trading. We do not have much of a clear boundary there, and the definition proposed, with its inevitable fuzziness at the edges, exacerbates that problem. I think that people will debate where they fit, and I am not sure that that sort of boundary debate is helpful in business. People do not run their business around regulatory boundaries and should not be required to do so.

Lord Flight: I do not think that you commented on pre and post-trade transparency.

Guy Sears: Yes, there should be a distinction both between pre and post-trades and between the different markets. The provisions in the proposal address equity in one place and allow rules to be made, and they address non-equity as if it was a single category in another. Of course, that does not mean that a legislator has to make only a single set of rules, but it is not an attractive opening that they are all corralled into a single provision.

The other concern with the pre and post-trade proposals is that there is always a risk of one arbitrary set of measures being replaced by another arbitrary set of measures. Moreover, the delegated powers in the proposal are completely open. They merely say that the rules may be made concerning pre and post-trade transparency. In other words, outcomes—the objectives and purposes—are not presently being set by our legislature in Europe. It does not say "in order to" or "for the purpose of"; there is merely a facility to make rules. From that point of view, of course we could have a debate whether "large in scale" should be this size or that size and what is the mid-point cross (waiver), which I think a couple of countries will try to get taken out entirely. At the moment it is just very open—the biggest concern is the width.

Q8 Lord Flight: Is the effect on liquidity not a concern?

Guy Sears: Pre-trade transparency for systematic internalisers, which sounds arcane, will govern the structure of the fixed-income market in Europe. If they impose pre-trade transparency requirements, whatever boundaries they set, this is about market restructuring in debt markets. That is probably one of the three most critical parts of MiFID II. The systemic internaliser, which in equities has never really meant much, is how debt markets operate. We operate by trading against the risk on the balance sheet of the banks. That pre-trade transparency is the most important part of the capital markets piece in terms of how badly it may go.

Christian Krohn: I completely support that and agree with it. There is a proposal for a systemic internaliser who agrees to quote prices to a client to make those prices firm for an indeterminate period and to make those quotes available to all his other clients. To the extent that those quotes are below a certain trade size, the other quotes, which he has to make available at the same price to his other clients, have to be transactable by those other clients. Thirdly, there is a proposal for public transparency of all quotes below a certain size.

There are all sorts of problems associated with these proposals. The requirement to make quotes firm is problematic because it will discourage systemic internalisers. It will discourage investment firms from making markets to provide liquidity, because they will not be able to revise or withdraw their quotes in the light of rapidly changing market circumstances, so there will be a drop-off in liquidity. The proposal to make quotes of a certain size available to all the other clients of a systemic internaliser is problematic because it completely ignores the reality that clients have different risk profiles. Indeed, the systemic internaliser would be required by other legislation—not least the capital requirements directive—to incorporate the risk of a given client into the price that he gives a given client, so the MiFID proposal is inconsistent with that risk profile requirement.

Thirdly, there is always a danger, particularly in less liquid, non-equity markets, that the public disclosure of a trade, however small, will have a negative market impact. The market will be able to infer the position of the client in question and trade against him.

Q9 Lord Jordan: I would like to talk about algorithmic and high-frequency trading, which many people said bears a lot of responsibility for what happened during the financial crisis. How would you assess MiFID II's proposals in relation to algorithmic and high frequency trading?

I also have a couple of sub-questions for Mr Krohn. Why do you believe that "the proposed requirement for the algorithmic trading strategy to post firm competitive quotes throughout the trading day is unworkable and would impede the functioning of European capital markets"? Also, can you explain the thinking behind your suggestion that trading venues should have market-maker schemes in place with a realistic set of incentives and obligations?

Christian Krohn: On the Commission's proposals on algo and HFT, we are supportive of the Commission's proposed requirement that all participants with direct access to a venue—that includes high-frequency trading firms, whatever they turn out to be—should be authorised, supervised and subject to appropriate pre-trade risk controls. AFME absolutely supports that. We also support the Commission's proposals for circuit breakers, which is the ability of regulated markets to ensure a pause for calm or pause for thought when there is too much volatility in a given stock in a short period.

We also support the Commission's proposals for order to trade ratios, which is the ratio of unexecuted orders to executed transactions. We think that that is helpful. However, we think that the order to trade ratio needs to be recalibrated, in the sense that we do not think that it is within the regulator's core competence to set order to trade ratios; that competence lies more with the venue in question, which will be closer to its own system and will know what its own system can or cannot handle. Also, on the circuit breaker issue, we welcome the proposal but we think that there needs to be harmonisation across Europe. Otherwise, there may be a gaming of the system.

Our main concern with the algo and HFT proposals relates to the de facto requirement for any entity that operates an algo to continue to make markets using that algo throughout the trading day. Irrespective of outside market conditions that could be extremely stressed and irrespective of the algo perhaps misfiring, the entity would have to stay in the market. We think that such a requirement is extremely problematic. Our counterproposal is along the lines that, if the operator of a market-making algorithm is the beneficiary of—or receives benefits in the form of rebates from—a venue to which it sends its orders, it should also be under a commensurate obligation to make markets in certain circumstances. However, there needs to be a safety valve for times of market stress and for times when the algo might misfire.

The Chairman: Does Mr Bates want to reply to that question and to the question on transparency?

Chris Bates: On the algorithm proposals, I think that the Commission's definition is unhelpful, in that it applies a label that appears to be narrow but is in fact very broad. The label is really about computer-assisted trading, which is really what the definition means. Once you realise that, you see the logic of the controls issue that Christian Krohn has already mentioned—computer-assisted trading requires adequate and appropriate controls both in the firm and in the venue—but it also makes it clear why the breadth of the proposal on market-making obligations is problematic. Anybody who uses computers to assist their trading—pretty much everybody—will have an obligation to make firm quotes. The starting point is: who are you really targeting this rule at? Even if you narrow the rule down, I still think that you end up with some of the issues that Christian Krohn has highlighted.

Q10 Lord Jordan: I would like to follow that up. We—and no doubt the people who eventually read our reports—would like to hear your definition of the purpose of high-frequency trading. Do you agree with the view that the increased use of automated trading might threaten the orderly functioning of markets in certain circumstances, where algorithms overreact to market events? Mr Sears, can you elaborate on your view that "High Frequency Traders bring valued liquidity to markets, but by the same token they can, if no control is exerted, cause markets to be disrupted by rapid price movements"? I ask this because many people have commented on Ferber's suggestion that all orders placed on a regulated market should be "valid for a minimum of 500 milliseconds"—that is not the average conversation, is it?

Guy Sears: I find this whole area difficult. On the one hand, is high-frequency trading filling our courts with barristers arguing over cost orders and over issues that are not actually concerned with any substantive dispute? On the other hand, Rothschild made his fortune at the battle of Waterloo by having co-location of agents and low-latency chartered ships to get information. Our job is to exploit information in the markets, so there is a reticence in that, if we seek to regulate some of those extremes, it is always difficult to know where to begin and end if you are asking market people. That said, it is clearly the case that there is a concern about this, and that is undoubtedly one of the reasons why I answered earlier that our interest is to ensure that we can choose where to interact with orders and with whom we interact.

On high-frequency trading, there is so much that needs to be done in terms of evidence. Looking at the issue more widely, I think that the need to ensure that there are appropriate systems and controls over our algorithms, over the algorithms that we rent from Christian Krohn's firms and over the electronic trading that goes on is a given. We fully accept that, and since 1 May we have been under best-efforts obligations to comply with the guidelines that ESMA has issued. On high-frequency traders, there is a very wide range of opinions. Some people think that they are mere rent extractors who do nothing for their money, whereas others believe that they add to the liquidity available at the touch. To paraphrase *Star Trek*—"It's life, but not as we know it"—one might say that this is liquidity but not quite as we know it, as it does vaporise at times. It is terribly difficult.

Exchanges should certainly have circuit breakers and controls in place when things get disorderly. Certainly, people should be regulated and subject to systems and controls rules and should be required to report. All those adequacies and tests should be done. Exchanges should perhaps not always—although I think that people have moved away from this design—employ tariff models that require people to trade in a way that just generates tariff. Just as the United States had a problem with people "trade shredding" in order to earn money from the consolidated tape, these things need to be looked at very carefully. However, at the end of the day, how do we stop certain sorts of trades? I do not know. We have continuous trading as our model. Does the buy side need continuous trading the whole time? Perhaps not. It is very interesting that everything goes back for closing auction on the London Stock Exchange, despite the fact that we talk about fragmentation. There are times when things have such wide societal value that we all come back together and trade.

The Chairman: Let us try to make some progress. The next question is from Lord Dear.

Q11 Lord Dear: Good morning, gentlemen. I will not weary you with individual questions, but I want to ask about the generality of third-country access. It would be helpful if you could say how you see the definition of "third country", which I think varies a bit and that sometimes skew the issue. As we all know, the Commission is proposing a harmonised framework for granting access to EU markets for third-country firms and market operators. How do you assess the Commission's proposals? What will be their impact on the financial services industry globally?

Chris Bates: It is important to begin by reminding ourselves that we are talking here about non-EU firms, which may be not just brokers, dealers or investment firms but banks as well. The Commission proposal is not explicit on this point, but a careful reading shows that it is a general proposal covering any non-EU firm that is involved in investment activity, whether it is a bank or investment firm. Therefore, it is important to think about two stages, the first of which is about the treatment of branches of non-EU firms within the EU. The most economically significant branches are probably the branches not of brokers, dealers or investment firms but of the international banks that have offices in London—offices of the same legal entity that is based outside the UK or the EU. Often, such branches will accept deposits and will also trade derivatives and securities. The current regime is that member states can allow those firms to operate as branches so long as they are not treated more favourably than EU firms, but unlike subsidiaries those entities do not benefit from a passport to do business across Europe. That fact has caused many banks to subsidiarise their operations by setting up subsidiaries so that they can operate fully. On the face of it, the Commission's proposal to allow branches of non-EU firms to have a passport sounds like a very liberalising proposal from its point of view.

The practical issue is that the passport is conditioned on the two core tests of equivalence and reciprocity. One can argue about whether equivalence can be achieved, but it can be tested. However, when you look at the variety of banks that have operations here—from the US to Taiwan—you wonder whether the equivalence test will be met. More importantly, the reciprocity test will be met by very few countries. Because of their market structure, very few countries allow European investment firms to establish branches in their countries, so inevitably most countries will fail this test. Therefore, under the Commission's proposal, all those foreign banks would have to stop trading derivatives and securities through their London branches. Is that something that London, or the UK, really wants to happen? The proposed regime appears to be generous or liberal, but I think that in practice the structure as proposed today would have significant negative effects on branches.

The second part is the cross-border business. Here, the issue is not just the 20 countries that have banks with offices in London, but the fact that entities in the UK—both large corporates seeking capital market opportunities and, more importantly, asset managers and broker dealers—do business with third-country firms within this broad definition in dozens of countries. The Commission's proposal, which is apparently liberal, says that those third-country firms can do business with EU firms so long as they pass this equivalence and reciprocity standard and so long as they stick to a narrow—an unduly narrow—range of services. Again, that is an apparently liberal approach, but in practice it will be significantly more obstructive to business than it appears, primarily because of how many of the dozens of countries around the world that would need to be tested would pass an equivalence standard and because of how few would realistically be expected to pass a reciprocity standard. On examination, this apparently liberal regime is significantly more restrictive than it would appear.

On the cross-border business side, that forces you back into the residual issue: how do you do business if you do not fit in that regime? What the proposal says is that you can only do business on an unsolicited basis. That is the source of the "Don't call us, we will call you" tag. That is not just not the way that business in the wholesale market works. People in asset management firms and brokerages want their non-EU firm—whether it be in the US or Peru or wherever—to provide them with research, trade ideas and other interactions. To say, "Don't call us, we will call you" is just not the way that business in the wholesale market works. For the cross-border wholesale business, we need a much more flexible model—more like the UK model, I might say.

The Chairman: Do our other colleagues broadly agree, or do they have anything that they would like to add to that?

Guy Sears: Very quickly, the third-country provisions refer to services being provided to clients. Because of the way that MiFID works, those clients are often authorised firms in the EU and fall within the regime, so all our firms are clients. Therefore, if we decide that it is in the best interests of our client to execute a trade with a US broker or use a Japanese manager for sub-delegation, that manager or broker is providing third-country services to us and would therefore need to have a branch or fulfil the reciprocity requirements. We have said that it is just nonsense to have such a requirement where we consume the service in the best interests of our clients. The answer that the Commission sent back to us—this is exactly as Chris Bates has said—was about solicitation: as long as you solicit it, that is fine. Frankly, if someone in a business in another country does not have the wherewithal to try to get hold of us and offer themselves, they should not be in business. The notion of solicitation is something that protects my mother from trading on the same day as she is cold-called. The notion that a firm of the size of our members does business on the same day as it is called by a Japanese manager, rather than having three months of due diligence along with legal documentation and visits and suchlike, just does not reflect reality. Narrowly and selfishly, we just think that where business is given to authorised firms in Europe, that just should not be seen as third-country business—that is us getting the job done. The alternative is that we sign the mandates in Singapore, and Europe will just be used for the sub-delegation.

Christian Krohn: I agree entirely with those points about the unintended consequences of the apparently liberalising regime. That is why we advocate a much more pragmatic approach to the application of the concept of equivalence. Such an approach would not be based on a line-by-line comparison of rules and regulations between member states and third-country jurisdictions but on regulatory objectives and desired outcomes.

We also want the Commission to have a look at the timing of its making of equivalence assessments. We are talking about north of 100 jurisdictions whose equivalence the Commission would potentially need to assess. To do that within a four-year timeframe seems unrealistic, especially given the other demands on scarce Commission resources.

The Chairman: I think that we have time for two more questions.

Q12 Baroness Maddock: My question is on the Commission's proposals to strengthen the role of the European Securities and Markets Authority. What is your view on that? In your view, where does the appropriate balance lie between the responsibility of ESMA and the responsibility of national regulators such as the FSA? I know that the evidence from IMA particularly mentioned "the balance of powers as between ESMA and national regulators, and the lack of transparency or accountability in the decision-making process".

Guy Sears: I think that regulation should be done where it can best be done. For example, if we are going to have short-selling bans, having disparate bans taking place at different times and in an unco-ordinated way across Europe is extremely unhelpful. ESMA has a role in ensuring control there. There are some areas in which the framework could be set by ESMA but there could also be national calibration. I think that we have to look at that on a case-by-case basis rather than follow orthodoxies of power and things like that. However, ESMA has been given so many roles at the moment that the reality is that the real control over ESMA is the extent to which the major competent authorities make people available to it. In practice, therefore, there is still retention of some control in each member state.

On the lack of transparency and accountability, I want to remind people not so much about our concerns over what ESMA can do in terms of product intervention but about the things around the FSA that people do not always think about. For example, regarding the assumption of legal privilege, the test of legal professional privilege employed by competition authorities in Europe is very different from that of the UK. Will ESMA be subject to that approach rather than the UK approach? There are assumptions about judicial review and about the nature in which the courts can intervene in the exercise of power by the Executive. How does that operate with ESMA under the treaty? Outside the directives, the panoply of things that assist in making the UK an attractive place to do business—which provide certainty about the way in which justice is administered—has yet to be seen in light of the exercise of the powers.

Christian Krohn: Our main concern with the delegation of powers or work streams to ESMA is the resources available to ESMA, which Guy Sears has touched on. Therefore, we advocate a more pragmatic approach that would allow ESMA the time and resources that it needs to deliver quality regulation or quality draft technical advice to the Commission on a timely basis and—perhaps more importantly from our perspective—along a timeline that allows for meaningful consultation with the industry rather than proposals being rushed through.

Chris Bates: This is not so much on the directive itself, but I think that the expansion of ESMA's direct supervision powers is an issue of concern. We need to get any expansion right. Clearly, the rule making, which is largely what we have talked about in terms of

ESMA's role in creating regulatory technical standards and advising the Commission on delegated acts, is now a sort of given; it is just a question of its scope and the timing allowed. I think that there is a greater debate about the extent of further expansions of direct supervisory powers over credit-rating agencies and trade repositories. You can see that these experiments—they are still new experiments in direct supervision at European level—depend upon a very small cadre of people. As Christian Krohn has mentioned, there are also issues about the processes and sanctioning working in very different ways from those that firms are used to. While I am not saying that they are inappropriate for those entities, I think that we need to scrutinise quite carefully proposals to extend the direct supervisory powers over firms, because some of these issues around the lack of discretion—for example, in the sanctioning process—would become of more concern if a broader range of entities were supervised at the European level. As we expand the European regulatory framework, that is a fairly significant issue lurking there, although it will probably appear not so much in this round of regulation as in the next.

The Chairman: Lord Vallance will ask his question and then we will need to finish the session. I apologise to Lord Marlesford.

Q13 Lord Vallance of Tummel: I declare an interest as a member of the international advisory board of Allianz SE and of the supervisory board of Siemens AG, which has a financial services arm.

My question is quite simple. How do you assess the new MiFID regime as it affects the regulation of commodity derivatives?

Christian Krohn: We understand the Commission's motivation and objectives in seeking to regulate commodity derivatives and emission allowances. The Commission sees a very fragmented space in terms of the powers that regulators throughout Europe have over monitoring the positions of entities in those markets and taking appropriate action, where action is necessary from a supervisory perspective. We understand the objectives, but once again we think that the proposal lacks the sophistication that it needs if it is to avoid damaging liquidity in those markets. When we referred to the one-size-fits-all approach, we were really referring to the implicit proposal that position limits would provide a panacea or solution that would limit volatility and speculation in the commodity derivatives markets. We think that position limits as a tool are a very clumsy instrument that risks having a materially negative impact on liquidity, investor choice and price formation in those markets. Instead, we advocate a spectrum of measures that regulators could require market operators to impose on participants in the commodity derivatives market.

On emission allowances, we understand the intention or objective to bring those within the scope of MiFID, but we are not convinced that it is appropriate to do so at this time. Bringing in emission allowances and considering them to be a MiFID financial instrument brings with it a whole host of other requirements, such as licensing, prudential requirements, conduct-of-business rules and so on. We just do not think that that is appropriate to the emission allowances regime at the moment. Instead, we propose that the Commission seek inspiration from REMIT—the regulation on energy market integrity and transparency—which proposes a registration regime for wholesale participants in the energy markets. We think that the inspiration for emission allowances could be sought there.

Q14 Lord Vallance of Tummel: Do you agree with the view that MiFID presents "an opportunity to curb excessive financial speculation on food prices", which has been seen as a particularly sensitive issue?

Christian Krohn: We understand the Commission's objectives in trying to regulate the commodity derivatives space, but we think that there needs to be a spectrum of sophisticated tools available for regulators rather than just saying that commodity derivatives per se are a bad thing because they are used for speculation on food prices.

Q15 Lord Vallance of Tummel: As food prices are particularly sensitive, should they form a particular component in that spectrum?

Christian Krohn: We would say that there is another side to that coin: there is the hedging of risk, which needs to be allowed for.

Chris Bates: As the impact of the changes in the licensing regime—the moving of the goalposts, if I may put it that way—has sunk in, I think that people have become concerned about the range of impacts on the whole chain of people involved in primary products, whether those be agricultural or other products, and the extent to which those changes have brought people into regulation who should not be under regulation. One concern about that change in the boundaries is that it is difficult to predict what the outcomes will be. There is no survey that tells you who has been brought into regulation and who has been left out. There is a genuine risk of unintended consequences.

On the treatment of emission allowances, I strongly agree with what has been said. Emission allowances are an underlying commodity in the same way as wheat or zinc or any other primary commodity is. It seems odd to leave those primary commodities outside this form of regulation while bringing one commodity—the carbon element—into regulation as though it were a financial instrument. I agree entirely with the registration regime for wholesale market participants in that. That is the appropriate way forward because you then find out who is in the market and who is trading and you can monitor their behaviour in terms of market abuse or other concerns without taking the whole baggage of MiFID, with its capital rules and client protections, which in most cases will be totally irrelevant to that business.

The Chairman: Colleagues, I am very grateful to you. I apologise to Lord Marlesford that we did not reach the question on inducements, but perhaps our witnesses can comment on that in writing. Indeed, they could perhaps write to us if there are other areas that they think we have not properly broached. I would be very grateful to hear any further views, given MiFID's breadth.

Please examine the transcripts that we send to you. Feel free to adumbrate anything that you wished to say but have not said by giving us additional information. I apologise for starting this session late, but I congratulate you on the high-speed trading of opinions and views that you have given us this morning, which has stimulated the interest of the Committee. We are very grateful for your very clear answers. With that, I thank you for coming and wish you a good day.

Christian Krohn, Association for Financial Markets in Europe, Chris Bates, Clifford Chance and Guy Sears, Investment Management Association (IMA) – Oral evidence (QQ 1-15)

Transcript to be found under Chris Bates, Clifford Chance

Professor Niamh Moloney, London School of Economics and Professor Emilios Avgouleas, University of Edinburgh – Oral evidence (QQ 33-50)

Transcript to be found under Professor Emilios Avgouleas, University of Edinburgh

Thierry Philipponnat, Secretary General, Finance Watch and Dr Kay Swinburne, MEP, Member, European Parliament, Economic and Monetary Affairs Committee – Oral evidence (QQ 16-32)

Evidence Session No. 2. Heard in Public. Questions 16 - 32

TUESDAY 29 MAY 2012

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.

Q16 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 corporations, enterprises and public entities can meet savings brought by private individuals. That is the purpose of MiFID. I will stop here on this question.[2]

[2] The witness adds: The OTC derivatives/EMIR rules pre-empt MiFID discussions on scope and make certain MiFID-provisions possible. It is essential to synchronize the two pieces of legislation.

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.

Q17 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.

Q18 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?

There is no major link between the short selling regulation and MiFID. Issues related to short selling, such as squeezes and securities lending, are addressed elsewhere in (forthcoming) legislation.

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.

Q19 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. 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.

Q20 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.

Q21 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.[3] 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

[3] The witness adds: Pre-trade transparency is needed for improved price discovery, post-trade transparency is needed for best execution.

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.

Q22 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.

Q23 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.

Q24 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.

Q25 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.

Q26 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.

Q27 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.

Q28 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.[4] 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 LIFFE 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

[4] The witness adds: By "HFT" I refer to intermediation by specialised participants who are flat at the end of the trading day, as described by Dr Swinburne, who can use technology to pursue predatory trading strategies, not to normal algorithmic execution on behalf of institutional investors.

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?

Q29 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.

Q30 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.[5] 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,

[5] The witness adds: To avoid regulatory arbitrage, it is essential that measures such as setting position limits and market abuse controls are taken at an international level. Our evidence shows that market participants' behaviour is not scrutinized as it takes place across platforms in multiple EU member states. In the absence of global supervision of market conduct as recently proposed by IOSCO, the most appropriate level of supervision would be at ESMA level. National supervisors should be competent for day-to-day supervisory activities such as authorisation of institutions and products, and granting of exemptions for position limits.

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.

Q31 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.

Q32 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 received 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.

Thierry Philipponnat, Secretary General, Finance Watch – Supplementary written evidence

Qn 5. What is your assessment of the role of Systematic Internalisers (SIs), and the Commission's proposals in relation to them?

Nothing to add.

Qn 11: The UK has already sought to ban commissions set by product providers for advisers of all types. Should the MiFID review be designed to reflect the approach taken by the FSA?

Yes. We support the FSA's general approach against inducements for advisors of all types. Our only comment is that for practical reasons, when this is applied to in-house sales of in-house products (which is the dominant model in some Member States) a simple ban may not be the best fit. We therefore suggest that for advisors in this situation, MiFID II should focus on detaching sales targets from compensation and staff evaluation.

Qn 12: The Committee is also scrutinising the Commission's Market Abuse Regulation proposals. What is your view of the proposals?

Nothing to add.

15 June 2012

Guy Sears, Investment Managements Association (IMA), Christian Krohn, Association for Financial Markets in Europe and Chris Bates, Clifford Chance – Oral evidence (QQ 1-15)

Transcript to be found under Chris Bates, Clifford Chance

Guy Sears, Investment Management Association (IMA) – Supplementary written evidence

Committee Question:

The UK has already sought to ban commissions set by product providers for advisers of all types. Should the MiFID review be designed to reflect the approach taken by the FSA?

IMA Response

From a consumer perspective, the Commission's proposal – a ban on payments/inducements from product providers to independent advisers only – is unacceptable. It is essential that new regulation does not create further distortions in the retail market place or allow ingrained conflicts of interest to continue largely unfettered. This can only be against the interests of consumers. But the FSA's approach is also not free from distortion.

First, by way of brief comparison of the two approaches:

- RDR covers all types of retail investment product providers. The MiFID proposals cover only MiFID instruments and structured deposits, with insurance products covered by the Insurance Mediation Directive. Proposals for the latter have still to be published and will be progressed along a different timeline, and technical standards arising from the new rules will be the responsibility of a different European Supervisory Authority (EIOPA as opposed to ESMA).

- RDR bans commissions paid to any form of advisers. The MiFID proposals relate to "independent" advisers only and there is no proper definition of independent (or of non-independent). Our European industry colleagues comment that no Continental advisers will call themselves independent, and the ban as drafted will therefore have no real effect in practice.

- The FSA has stated that it intends to ban rebates going direct to clients, but draft rules are long-awaited. The Commission's proposals contain no such ban.

- RDR introduces a new definition for a subset of execution-only distributors called "platforms", which creates a new distortion within the execution-only market. Most other Member States do not comprehend such a distinction and the introduction of such a definition in EU legislation is, therefore, highly unlikely.

- RDR is explicit that providers can "facilitate adviser charging" out of the product (provided they do not dictate the quantum), but if rebates direct to clients are banned, then this facilitation cannot work effectively for collectives (whereas it is feasible for the balance sheet products of banks and insurers). The MiFID proposals are silent in this regard.

Although the RDR approach is arguably less distortive, we believe that neither approach will optimally deliver the intended policy aims. Moreover, there is a real risk that EU citizens with only modest amounts to save will not be able to afford to pay for proper advice and will be more vulnerable to biased sales practices, at the very time that they are being encouraged to take increasing responsibility for their retirement provision.

The attached paper considers conflicts of interest in more detail and suggests a modified approach, based on the RDR rules already adopted, which we are proposing within Europe:

- product providers should disclose at least annually how much they receive from the product in direct charges or broad equivalents (links to the PRIPs initiative);
- product providers and non-advisory distributors should disclose clearly (in monetary terms) how much commission/rebate they receive from a(nother) product provider;
- no commissions payable direct to any advisers (either independent or non-independent), for <u>any</u> products;
- but rebates/commissions can be paid direct to investors' accounts;
- adviser's charge must be explicitly agreed with the investor and cannot vary inappropriately depending on the product or the product provider;
- the product provider cannot influence the amount of the adviser's charge.

How will ordinary EU citizens access financial advice?

<u>The context</u>

EU governments have known for many years that the current system of income in retirement being largely or wholly provided by the State for most of its citizens is not sustainable, though few countries have so far made major inroads to tackling the issue. Citizens of all Member States will increasingly need to make their own provision for the retirement phase of their lives. Also, we need to move away from a debt culture: we need to save, rather than borrow, for pre-retirement expenditure. Therefore, an increasing number of EU citizens will need at least initial financial advice, and many will need regular or periodic advice.

As now, the wealthy will have a number of options for accessing quality advice and can pay for it. For others, improved financial education in schools and during higher education, coupled with the use of internet information and comparison sites, could lead over a couple of generations to a strong cadre of self-directed savers and investors. But what about the millions of EU citizens with only very modest amounts available for saving, who do not have the confidence or ability to be entirely self-directed? And how will such citizens be able to access advice on a regular savings plan when they do not have a lump sum to pay for that advice?

Commissions can help to spread the cost of advice over time. However, the current system of advisers (both tied and independent) being paid out of the product at rates generally dictated by the product providers, with minimal disclosure to consumers, has led to product and product provider bias, to the detriment of consumers. MiFID and IMD rules were intended to address this, but they have not. That failure is perhaps due to a combination of factors: insufficiently articulated rules; inconsistent implementation between Member States; weak supervision or enforcement by national regulators; and ingrained industry practice and conflicts of interest. Moreover, structured deposits are at present subject to no EU rules on inducements.

The Commission's proposals

The Commission's MiFID II proposals bring structured deposits into scope, which is necessary and welcome. But, as they stand, the proposals will not remove commission/brokerage bias. Indeed, the suggestion that inducements will be banned only for "independent" advisers (a loosely defined term) will create distortions in the advice market and entrench the behaviours of some tied advisers. The limited progress towards "open architecture" will likely be reversed, and banks and insurance companies will again "advise" their customers to buy only their own products. The mass movement of ordinary banking customers' savings from funds to deposits post-crisis is very telling. A further concern is that we have still to see the Commission's proposals for IMD II. It is the UK's experience that material product bias has been evidenced by advisers selling insurance products over funds, with the former giving higher levels of commission at the point of sale.

It is essential that any new requirements or prohibitions should apply to <u>all</u> types of advisers, for <u>all</u> types of retail investment products.

Is a ban necessary?

We agree that there have been failures in the mass retail marketplace that need to be addressed and that rules in this area need to be improved. Many retail consumers do not have a real understanding of the inducements paid on an on-going basis to intermediaries and/or their purpose. Indeed, many are unaware that such payments are made at all, having received no more than a statement hidden in the "small print" of the original contract that refers to a very small percentage being deducted from their investment to pay the intermediary.

We therefore agree that current arrangements regarding inducements are inadequate. We do not agree, though, that disclosure *per se* has failed or that a ban on inducements is necessarily warranted at this stage.

Instead, we suggest that intermediaries be required to provide regular statements (e.g. annually) to their clients, perhaps in a standardised format, of the <u>amounts</u> they receive from different product providers from or out of their investments in particular products in which they are invested. This would remind consumers that such payments are being made and give them an immediate understanding of the amounts involved.

However, we acknowledge that such disclosure, alone, may be insufficient to address concerns about poor quality and conflicted advice. Improved disclosure requirements would need to be augmented by other provisions. For example, the adviser's fee should be explicitly agreed between the adviser and its client, and should not vary inappropriately according to the type of product offered or the choice of product provider. Commissions could be used to (part-)fund this fee, but should not be allowed to influence its size.

If the balance of opinion is that a ban on commissions is necessary, then it should cover:

- <u>any</u> forms of commission, brokerage or other financial incentives (including staff bonuses based on sales volumes),
- paid by <u>any</u> product provider or out of <u>any</u> retail savings/investment product, and
- to <u>any</u> form of adviser.

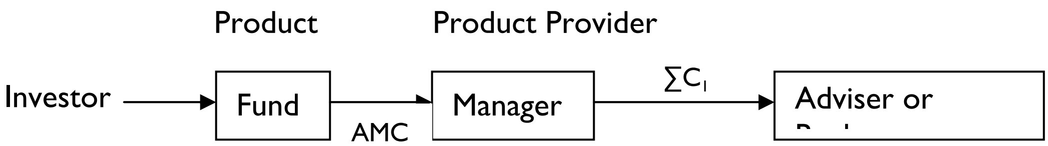
Otherwise, there will be on-going bias as between product types and as between types of adviser, to the detriment of consumers.

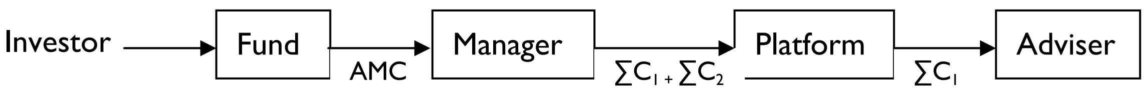
But even a wider-based ban would not ensure consumers received quality advice and would likely leave most citizens with modest means unable to pay for the advice they need. Also, it would create a distortion with execution-only, bank and insurance distribution channels, which could continue to buy product in bulk at discounted prices.

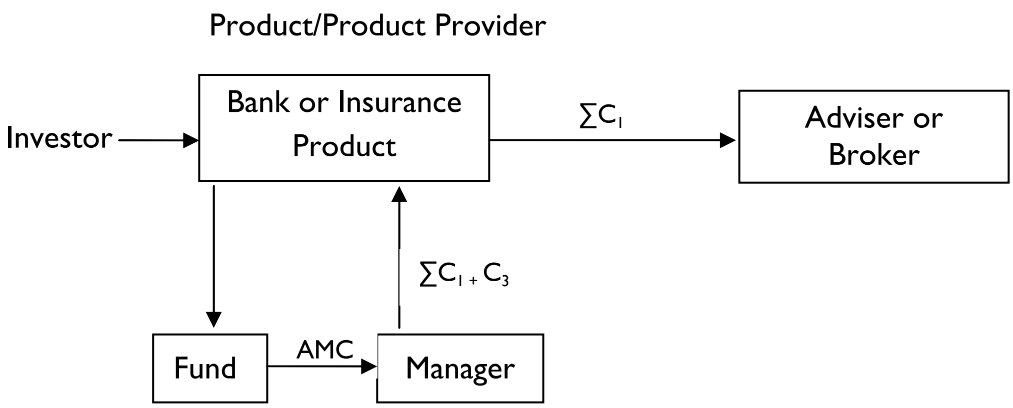
The remainder of this paper offers thoughts on a modification of the Commission's proposal to address these concerns.

<u>An improved commission system</u>

At present, advisers and entities offering execution-only services of any kind (including platforms and brokers) can receive commissions out of the product or from the product provider, subject to existing MiFID provisions on inducements. They receive regular amounts aggregated for all their clients invested in that product, with that product provider or via that platform. Also, banks and insurers can negotiate price rebates.



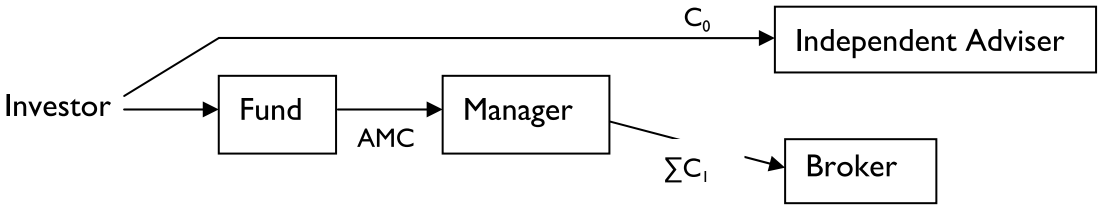


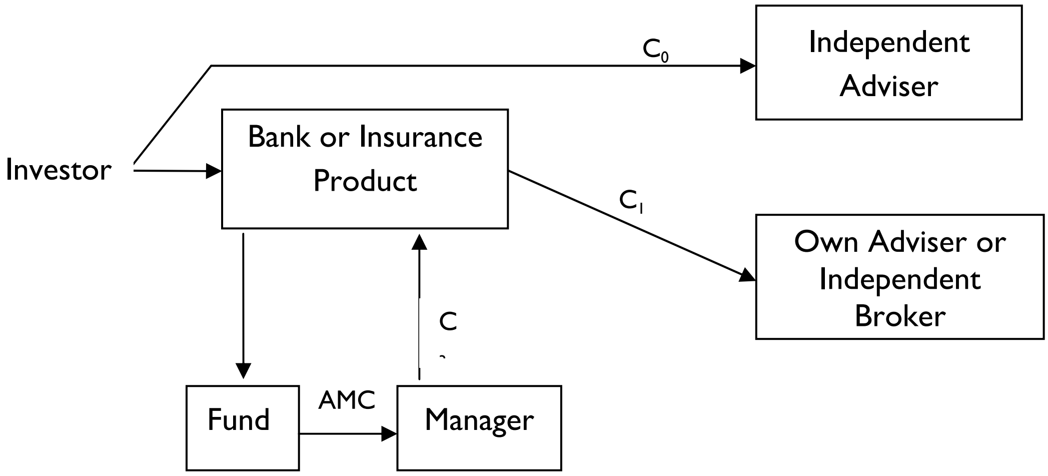


AMC = Annual Management Charge

C_1 = commission paid to adviser/broker for each investor
C_2 = commission retained by platform for each investor
C_3 = commission retained by bank or insurance company on its aggregate holding in the fund

The Commission's proposal would mean:





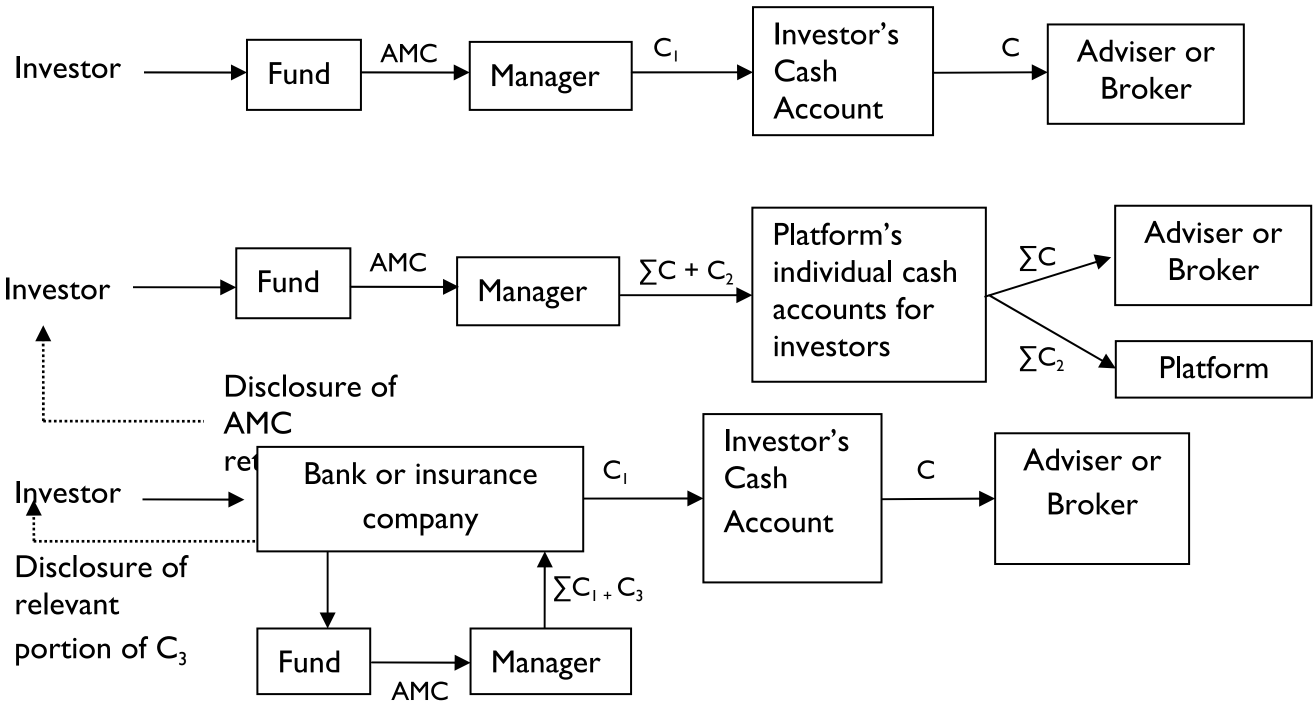
For lump sum investments, the adviser can charge a one-off fee for the advice. But those advising individuals investing a modest sum each month, say, will have to establish a system with each investor to receive regular, very small sums. This will be very costly. In practice, this can only mean that C_0 will need to be significantly higher than C_1.

Indeed, low levels of investment will be uneconomic for advisers, even with higher commissions. Therefore, many EU citizens will not be able to access independent advice. Regulation will have pushed them towards the biased advice offered by bank and insurance staff.

The modified proposal:

– ***product providers must disclose at least annually how much they receive from the product in direct charges or broad equivalents;***
– ***product providers and non-advisory distributors must disclose clearly (in monetary terms) how much commission/rebate they receive from a product provider;***
– ***no commissions payable direct to any advisers (either independent or non-independent), for <u>any</u> products;***
– ***but rebates/commissions can be paid direct to investors' accounts*** *[not banned under the Commission's proposal, but needs to be made explicit]**;***

- ***adviser's charge must be explicitly agreed with the investor and cannot vary inappropriately depending on the product or the product provider;***
- ***the product provider cannot influence the amount of the adviser's charge.***



C= commission agreed by investor as payable to the adviser.
If $C<C_1$, then excess remains with investor
If $C>C_1$, then investor may need to top up cash account (unless other amounts are credited to it, e.g. fund distributions).

Given that such a system will enable advisers to continue to receive commissions via an operationally efficient and certain process (albeit that the amount of commission will not be dictated or influenced by the product or product provider), it is to be expected that C will be less than C_0 under the Commission proposal. This will enable more EU citizens to access and pay for financial advice and to benefit from the bulk discounts negotiated by aggregators.

<u>Bulk discounts</u>

The retail market place in all Member States is increasingly intermediated, with various forms of "aggregators" enabling operational efficiencies between product providers and consumers (or their advisers). The degree of intermediation is particularly marked in the UK funds market, with only a very small percentage of business coming to the fund or manager direct.

It is a common feature of markets in general that those who buy in bulk can generally negotiate lower prices. They enable the seller to distribute their products more efficiently and quickly, and they provide one-stop-shops for the end-buyers of the product.

Wholesalers – in this context, "aggregators" of order flow – are businesses. They need be viable (i.e. they need to make a reasonable profit). They extract "rent" from the market in exchange for facilitating operational efficiency and providing other services, for both product providers and end-customers.

In relation to financial services of any kind, most retail consumers are considering less knowledgable than product providers and intermediaries. They are therefore vulnerable to the potentially adverse impacts of asymmetry of information, conflicts of interest and concentration of power. Regulation is necessary to protect retail consumers from detriment. But it should not frustrate or prevent the industry from achieving economies of scale, which are in the interests of consumers as well as the industry.

Where the benefits of aggregators (as bulk buyers) are passed on to consumers, and where those benefit are not used to distort adviser recommendations, they should be able to continue. If they are unnecessarily prevented from so doing, regulation will have done consumers a dis-service.

The modification described above would enable investors to continue to benefit from the bulk discounts negotiated by aggregators of any type. Critically, it would also address the potential distortion whereby banks and insurers could continue to negotiate rebates of fund AMCs, and produce packaged bank and insurance products at apparently favourable prices, without disclosing any rebate they have retained.

A final point on the quality of advice

It is reasonable for consumers to be able to expect that those providing advice (whether independent or not) are appropriately qualified to do so. Unlike the "advice" given by the salesperson in an electrical appliance shop as to which washing machine to buy, financial advice can have major ramifications (good or bad) for a person's long-term wealth and well-being.

IMA has therefore long-supported the strand of the FSA's Retail Distribution Review that relates to a minimum qualification requirement for all types of advisers. The new minimum requirement is not especially demanding (equivalent to the first level of a degree course) and very many advisers are significantly better qualified than this. But a small number of IFAs, whose recommendations have been influenced more by commission levels than rigour of their analysis, will leave the industry. And, importantly, bank and insurance staff will not be able to hold themselves out as advisers (even as non-independent advisers) without being qualified.
Professional institutes will periodically assess individual advisers' recommendations and the FSA will require regular reporting from advisers on which products they have recommended. These mechanisms will enable behaviours to be monitored over time.
We note that the Commission's proposals include no specific provisions relating to minimum qualifications for advisers.

29 May 2012

Dr Kay Swinburne, MEP, Member, European Parliament, Economic and Monetary Affairs Committee and Thierry Philipponnat, Secretary General, Finance Watch – Oral evidence (QQ 16-32)

Transcript to be found under Thierry Philipponnat, Secretary General, Finance Watch

Dr Kay Swinburne, MEP, Member, European Parliament, Economic and Monetary Affairs Committee – Supplementary written evidence

5. What is your assessment of the role of Systematic Internalisers (SIs), and the Commission's proposals in relation to them?

- Given there are only 12 registered SIs in the EU, and only 2 of them have significant flow, it is hard to assess the SI regime for equities as anything other than a failure. Clearly the regime is not optimal for trading and the idea that banning the use of OTC trading would force people to use them is misguided.

- However, they may have a place in the fixed income world as more transparency will lead to more organised trading and given an appropriate regulatory regime regarding the posting and updating of quotes, it could be a good alternative for products that are not liquid enough to trade on venues but require more transparency. However this would require changes being made to the commission's proposals as the regime currently is very much left to the level 2 and has little detail (no doubt because it has had so little use in the equity markets) and concerns about pre-trade transparency for some products exist.

11. The UK has already sought to ban commissions set by product providers for advisers of all types. Should the MiFID review be designed to reflect the approach taken by the FSA?

- The Commission proposal introduces a distinction between independent advisers and other types of advisers, and only bans inducements for independent advisers. It also does not really tackle the issue of tied agents. As a framework it does not provide a level playfield and does not appropriately address the needs of consumers.

- The UK RDR suits the UK market which is predominantly IFAs, I think it should be the gold standard that the rest of Europe aims for, however, the models of distribution in continental Europe are based around distribution by banks. If we tried to impose the RDR on the rest of Europe I am not sure whether consumers would really end up with better advice.

- That being said, I am very concerned that if the UK presses ahead with the RDR, non-UK IFAs operating under the less stringent requirements of MiFID will be able to passport into the UK and provide services to UK consumers who will think they are protected by the RDR when they are not. Many UK IFAs could go and register in another Member States and then come back into the UK, thereby avoiding the RDR entirely.

- The only solution I have found to this so far is to look at a hard disclosure regime for investment advice within MiFID, whereby all advisers, be they independent, dependent or a tied agent, have to disclosure in one standard format all of the costs associated with the advice they give including those that are paid by inducements - I have even suggested a format for doing this, based upon the proposals of the "Free and Fair" campaign. In that way there would at least be comparability between the different methods of distribution.

- One of the most important aspects of the RDR that MiFID should seek to introduce across the EU is a requirement for Member States to impose a minimum qualification level for those who give financial advice. It should be tailored to meet the needs of consumers in each member state but should provide some benefit to consumers as they buy investment products for retirement.

12. The Committee is also scrutinising the Commission's Market Abuse Regulation proposals. What is your view of the proposals?

To a large degree the MAR proposals reflect ways in which the UK FSA has already gone beyond the first Market Abuse Directive. As EU financial markets become more integrated it makes sense that the rules concerning abusing them also become more standardised.

- The benefit of the new regulation is that it will provide legal certainty for market participants about how rules will be applied and should give them greater confidence in using newer markets.

- I have some concerns over how insider trading is defined as it seems it might prevent companies from engaging in legitimate research or from doing general due diligence and performing their role within corporate governance as shareholders. Also some of the provisions around Chinese walls could cause unintended implications because of the very wide definition of what could be construed as "relevant information" however I am confident that this can be cleared up.

- The biggest concern I have is that the standards will not come up to the high standards we already have in the UK. There is a discussion in both the Parliament and the Council surrounding limiting provisions around telephone recording so minutes could be kept of conversations instead of an actual recording, a concept that would be a huge step backwards for the UK markets. There is also a debate around a cap on the fines that the national regulators can impose which would be harmful to a financial centre like London that is attractive to international investors partly because it has a strong reputation for cracking down on market abuse by having the capacity for unlimited fines for abusive behaviour.

- The other concern I have with regards to the Mark Abuse dossier is the way that it has to separate out criminal sanctions for market abuse into a separate directive. While this is obviously inline with the treaty and ensures that the UK can opt out of it, I would like to ensure that there are no incongruities between the regulation and directive, particularly surrounding definitions. At the moment there are five EU Member States that do not impose criminal sanctions under national law at all, this clearly needs to be rectified to ensure a level playfield. In the UK context in is important that the separation into two pieces of legislation does not mean that the FSA has to decide before it launches a case whether it will be criminal or administrative as obviously this can change over the course of an investigation.

- A further concern is that the Rapporteur for the Parliament's text has introduced some conflicting requirements to the MiFID proposal within MAR around the OTF category and treatment of High Frequency Trading. However both Rapporteurs have pledged to work together on these issues and ensure that the final texts do not contradict one another.

29 May 2012