

Opinion of the European Economic and Social Committee on the 'Proposal for a Regulation of the European Parliament and of the Council on markets in financial instruments and amending Regulation (EMIR) on OTC derivatives, central counterparties and trade repositories'

COM(2011) 652 final — 2011/0296 (COD)

(2012/C 143/14)

Rapporteur-general: **Mr IOZIA**

On 15 and 25 November 2011 the European Parliament and the Council respectively decided to consult the European Economic and Social Committee, under Article 114 of the Treaty on the Functioning of the European Union, on the

Proposal for a Regulation of the European Parliament and of the Council on markets in financial instruments and amending Regulation [EMIR] on OTC derivatives, central counterparties and trade repositories

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On 25 October 2011, the Bureau of the European Economic and Social Committee instructed the Section for the Single Market, Production and Consumption to prepare the Committee's work on the subject.

Given the urgent nature of the work, at its 478th plenary session, held on 22 and 23 February 2012 (meeting of 22 February), the European Economic and Social Committee appointed Mr IOZIA rapporteur-general and adopted the following opinion by 99 votes in favour, with 5 abstentions.

1. Conclusions and recommendations

1.1 The EESC welcomes the Commission's proposal for a regulation and hopes that it will be adopted swiftly in order to make the protection it offers to savers more effective and to apply the principles it sets out to all financial instruments ⁽¹⁾.

1.2 The EESC notes that the proposal for a regulation aims to:

- improve trade transparency and the provision of transaction data to the competent authorities;
- make trading in derivatives on organised venues mandatory;
- facilitate the removal of barriers to non-discriminatory access to clearing facilities;
- increase supervision of financial instruments and positions in derivatives;
- monitor the provision of financial services by third-country firms without a branch in the EU;
- monitor and reduce the impact of computer-driven and algorithm-based trading methods.

1.3 The draft regulation increases market transparency and contains measures to reduce fragmentation. Ensuring uniform application of the rules avoids the risk – which is very high in the financial markets – of regulatory arbitrage, and is expected to bring final users the advantage of lower transaction costs (at least in theory).

1.4 In its legislative proposals the Commission should highlight the advantages of the rules for the various parties concerned: individual users of financial services, small and medium-sized enterprises, market operators, government.

1.5 One general measure which the Commission should strongly promote is a programme of financial education. The EESC reiterated this recently in an own-initiative opinion ⁽²⁾.

1.6 Although the costs deriving from the new regulation do not appear too significant, the EESC is concerned at the possible macroeconomic costs for the financial system which do not seem to have been appropriately considered in the impact assessment. For some time and on several occasions the EESC has called for "a profound study on the [effects of the] cumulative regulatory initiatives (...) for the necessary measures on the financial system and the capital market. A stable and efficient system should promote financial stability and liquidity for the real economy" ⁽³⁾. The EESC is pleased that the Commission has decided to initiate such a study, which is essential in order to understand the overall effect of all the regulatory measures, and it hopes that the study will be published soon.

⁽¹⁾ OJ C 54, 19.2.2011, p. 44.

⁽²⁾ OJ C 318, 29.10.2011, p. 24.

⁽³⁾ OJ C 107, 6.4.2011, p. 21.

1.7 The EESC points to a problem of compatibility between Article 40 of the regulation (delegated acts) and Article 290 TFEU. The number, content and provisions of the delegated acts are not consistent with the provisions of the Treaty and place too many fundamental aspects of the regulation outside the scope of the normal legislative process. The EESC recommends that serious thought be given to ways of bringing Article 40 fully into line with the provisions of the TFEU.

2. The proposal for a regulation

2.1 In recent years, financial markets have changed enormously. New trading venues and products have come onto the scene and technological developments such as high frequency trading have altered the landscape.

2.2 The proposals aim to make financial markets more efficient, resilient and transparent, and to strengthen the protection of investors. The new framework will also increase the supervisory powers of regulators and provide clear operating rules for all trading activities.

2.3 Key elements of the proposal

2.3.1 More robust and efficient market structures: MiFID already covered Multilateral Trading Facilities and regulated markets, but the revision will now bring a new type of trading venue into its regulatory framework: the Organised Trading Facility (OTF). These are organised platforms which are not regulated but are playing an increasingly important role. For example, standardised derivatives contracts are increasingly traded on these platforms. The new proposal will close this loophole. The revised MiFID will continue to allow for different business models, but will ensure all trading venues have to play by the same transparency rules and that conflicts of interest are mitigated.

2.3.2 Taking account of technological innovations: furthermore, an updated MiFID will introduce new safeguards for algorithmic and high frequency trading activities, which have drastically increased the speed of trading and pose possible systemic risks.

2.3.3 These safeguards include the requirement for all algorithmic traders to become properly regulated and provide appropriate liquidity. There will be rules to prevent them from adding to volatility by moving in and out of markets. Finally, the proposals will improve conditions for competition in essential post-trade services such as clearing, which may otherwise frustrate competition between trading venues.

2.4 Increased transparency: by introducing the OTF category, the proposal will improve the transparency of trading activities in equity markets, including "dark pools" (trading volumes or liquidity that are not available on public platforms). Exemptions would only be allowed under prescribed circumstances. The

proposal will also introduce a new trade transparency regime for non-equities markets (i.e. bonds, structured finance products and derivatives). In addition, thanks to newly-introduced requirements to gather all market data in one place, investors will have an overview of all trading activities in the EU, helping them make a more informed choice.

2.5 Reinforced supervisory powers and a stricter framework for commodity derivatives markets: the proposals will reinforce the role and powers of regulators. In coordination with the European Securities and Markets Authority (ESMA) and under defined circumstances, supervisors will be able to ban specific products, services or practices in case of threats to investor protection, financial stability or the orderly functioning of markets.

2.6 Stronger investor protection: building on a comprehensive set of rules already in place, the revised MiFID sets stricter requirements for portfolio management, investment advice and the offer of complex financial products such as structured products. In order to prevent potential conflict of interest, independent advisers and portfolio managers will be prohibited from making or receiving third-party payments or other monetary gains. Finally, rules on corporate governance and managers' responsibility are introduced for all investment firms.

3. Comments and points for consideration

3.1 According to data provided by the Bank for International Settlements, the notional value of derivatives in circulation rose from USD 601 046 billion in December 2010 to USD 707 569 billion in June 2011 (BIS Quarterly Review, December 2011).

3.2 The new proposal aims to increase the efficiency, integrity and transparency of markets, especially less-regulated markets, and thus increase investor protection.

3.3 The last 20 years have seen an explosion in global transaction volumes which has injected large quantities of liquidity into the financial markets. This unprecedented growth, mainly driven by short-term speculation, has not been matched and supported by corresponding growth in the real economy, the labour market and wages. The EESC thinks that the proposal for a regulation is necessary and a suitable way of helping to mitigate these effects on the markets.

3.4 The original role of the financial markets is to support economic development by reducing information asymmetries and thus promoting the efficient allocation of resources. As already pointed out, the crisis has highlighted a fault in the market mechanism, with market operators acting in accordance with different principles from those of the information economy and using the financial markets purely for short and very short-term speculation.

3.5 Our markets have thus been flooded with very short-term liquidity and have lacked (and continue to lack) incentives to foster real industry rather than the finance industry. This behaviour further exacerbates the unnatural split between industry and the financial markets which are creating instruments that are increasingly unclear, abstract and complex.

3.6 Speculation is part of the way the market operates and is inherent to the market, ensuring liquidity and identifying anomalies, but very short-term speculation, on the other hand, serves no economic or social purpose and contributes significantly to the development of financial bubbles. There is an urgent need to reverse the current trend, shifting investors' focus back onto real growth.

3.7 In this light, the proposal provides undoubtedly sound measures and instruments for addressing the clear shortcomings and imbalances in our system.

3.8 The new set of rules on organised trading systems makes all trading activity subject to more explicit operating rules. Portfolio management services, securities investment advice and the supply of financial products are subjected to rigorous standards. The new legislative provisions, which lay down new requirements regarding the liability of managers and the revision of corporate governance, will require intermediaries to undertake major corporate reorganisation. The EESC thinks that these new rules, although onerous, are appropriate and consistent with the objectives of the regulation.

3.9 The proposal for a regulation introduces *Organised Trading Facilities* (OTF), which the EESC supports, providing they make it possible to integrate the various trading systems used by different counterparties. This system will benefit the market as a whole, by highlighting opportunities for using different, competing instruments, while requiring that the principle of best execution be maintained.

3.10 The regulation assigns special powers to the authorities in connection with sales to clients of products and services which could seriously jeopardise the interests of investors as well as market stability.

3.11 The principle of transparency is applied not only to markets but also to the authorities. The competent authorities may exchange information on transactions, thus avoiding the risk of possible market abuses. The EESC strongly welcomes these aspects of the proposal for a regulation which constitute effective action to strengthen investor protection.

3.12 According to authoritative market operators, "the new rules are fundamentally important – they will change the

structure of European financial markets". For instance, there is an inherent systemic risk that should be borne in mind, which was revealed in the recent financial crisis. If a bank defaults, this can jeopardise delivery on the obligations taken on with OTC trading and the risk can therefore be passed on to its counterparties, to other entities. The new rules reduce the counterparty risk relating to the OTC market. The proposal for a regulation will significantly reduce OTC transactions.

3.13 Another aim of the new regulation, which the EESC regards as extremely positive, is to achieve consolidation of data on all OTC trading, not just that cleared through central counterparties (CCP). The data will be made available to the supervisory authorities, enabling them to monitor the market effectively, which is currently not possible owing to lack of data. However, in these respects the regulation sets out an open structure which is not pre-defined. For example, it will be up to operators or ESMA to identify the eligible classes of derivatives that must be centrally cleared. It is therefore not possible at present to specify which of the current transactions will actually be affected.

3.14 Another key aspect is the fact that the future European regulation gives no recommendation regarding the future CCP market structure. Thus, either the existing structures in the individual Member States, such as for example the Italian Stock Exchange's CCP, the *Cassa di Compensazione e Garanzia*, could be strengthened, or a small number of large, Europe-wide bodies will emerge. These are just possibilities, not mentioned in the regulation. Irrespective of the particular structure chosen, however, the fundamental importance should be stressed of how risk management activities are managed and of efficient oversight mechanisms to prevent further disastrous defaults.

3.15 Moreover, the process of standardising trading and making it subject to central clearing should reduce costs. The consolidation process could undoubtedly have this effect, but we cannot say for sure. If implemented properly, the new regulation will lead to better assessment of risks which have often been underestimated in the recent past by credit intermediaries seeking bigger sales volumes and short-term profits.

4. Some criticisms

4.1 One area of concern is the costs of implementing the regulation, which appear to be understated and which come at a time when financial institutions are already under pressure in terms of regulation, profitability and costs. Financial institutions have to be efficient and support the economy but also maintain an appropriate level of profitability. There are fears that costs could be passed on to investors and clients. The EESC considers that users and companies, particularly SMEs, should be protected from this.

4.2 According to the Commission, the one-off compliance costs will amount to between EUR 512 and 732 million, with ongoing costs of between EUR 312 and 586 million. These figures appear too low. For example, the operating costs of establishing the technological infrastructure needed for the data reporting requirements alone are open to doubt and could on their own exceed the total figure. The Commission has finally launched a study to evaluate the total impact of the cumulative costs arising from the new regulatory initiatives, which the EESC has been calling for for some time. It is to be hoped that the study will be completed and published swiftly to provide a comprehensive picture of the impact of the regulation in terms of time and cost.

4.3 If changes to the overall rules continue to increase costs and complexity for financial institutions, they are likely to consider suspending certain areas of their business or relocating them to a different jurisdiction.

4.4 Although the principle of reducing risk through improved transparency will be welcomed by many, we need a better understanding of the overall impact of the rules on Europe's ability to compete in the global financial services market.

4.5 We also need to ask who are the real, direct beneficiaries of this increased transparency. Investment banks and hedge funds will certainly benefit from more information, but can the same be said of commercial markets?

4.6 The EESC wonders whether the highly prescriptive regulation of "dark pools" could compromise the ability of companies managing people's savings to trade as efficiently as possible for their own clients (essentially retail clients).

4.7 One of the objectives of the proposal for a regulation is to unify, harmonise and integrate financial markets. Retail

investors are often not aware of all the financial instruments available to them on their own local market. Although the EESC supports the principle of consolidating the various trading platforms, at the same time it recommends that the Commission promote financial education programmes as a matter of urgency. The Committee believes that, without appropriate investor preparation and awareness, the current process of harmonisation risks falling short of the hoped-for results.

4.8 One of the most important implications of the new regulation is the enlargement of the range of asset classes to which it applies: in addition to shares, the regulation is simultaneously intended to apply to all other financial instruments. If the thrust of this regulation towards competitive trading based on clearing of quoted derivatives is maintained, it will have very significant implications for the structure of the market. Some fixed interest markets, which are already using electronic platforms, are perhaps the most likely candidates for rapid progress in this direction.

4.9 Article 40 of the proposal for a regulation sets out a long and detailed list of delegated acts which the Commission may adopt. The content of these acts is rather wide (to quote just a few examples: specifications for bid-ask quotes, order types and sizes, the information which regulated markets and investment companies are required to publish in respect of each category of financial instrument etc). The EESC points to a problem of compatibility between the Article 40 and Article 290 TFEU, as amended and included in the Lisbon Treaty. The relevant Treaty article states that "A legislative act may delegate to the Commission the power to adopt non-legislative acts of general application to supplement or amend certain non-essential elements of the legislative act". Looking at the elements of the proposal for a regulation which can be delegated, the EESC considers that they are essential rather than marginal. It therefore considers that the list of delegated acts in Article 40 of the regulation is superfluous, excessively long and inconsistent with the TFEU.

Brussels, 22 February 2012.

The President
of the European Economic and Social Committee
Staffan NILSSON
