

# **MiFID**

## **Speech by Sharon Bowles MEP Chair Economic and Monetary Affairs Committee Commission Public Hearing on MiFID 20 September 2010**

Thank you, Commissioner for inviting me to address this conference.

I should like to start by pointing out that MiFID is one of the most significant pieces of legislation that we have, because it is about the way in which capital flows into the economy. Markets are about funding growth and hedging risks and are of paramount importance to the economy, jobs, investments and pensions.

It is easy, politically, to get caught up in the latest happening, such as the CME test or the flash crash, and while we should draw lessons from such events it must not distract us from our main aim - which is to look at the ultimate needs of users and investors. So that is my starting point for measuring the success of MiFID and how it should be updated.

Users and investors need choice and protection.

Choice stimulates responsible innovation and reduces costs. Applied to trading, this means a choice of venues to meet investors' particular needs. There is no doubt that in many Member States the objective of choice, competition and innovation has been delivered by MiFID - and we must keep it that way, drawing in the laggards, consolidating the fruits of competition not stepping backwards.

Protection is needed so that in the wilds of the markets investors are alert to situations - not left unable to find out what is going on - and sheltered from what might be phrased as 'interesting' sales techniques. Certainly MiFID does some of this but quality and consistency of transparency information, including its timing, needs to be improved and is vital to mitigating fragmentation.

In pursuit of these objectives - of choice and protection - it is necessary to make the right calibrations to maintain deep and efficient markets.

With regard to transparency there are times when we have to recognise that in support of efficiency and protection the needs, interests and incentives of the individual and the whole are not always the same. That can present tough political decisions, so it is necessary to have firm principles that are understood at all levels and from which we can establish priorities and practices.

Among these principles are:

1. Recognition of the difference between wholesale and retail markets;
2. Establishing non-discrimination at all levels - pre, between and post trade – so that there is both choice and regulation that is appropriate to its level;
3. Recognising that liquidity and transparency can sometimes be a trade off and that different asset classes behave differently; and
4. With markets, we should remember that they can not be forced: in order that they exist there must be a willing buyer and a willing seller. This should not be taken for granted and what we do will affect appetite, and in turn the economy and people's lives.

These needs and principles lead me to analyse three substantial and overlapping areas: Transparency, Competition and Data.

### Transparency.

On transparency, have we now got the right balance pre trade on equities? The issue of lit versus dark venues is one that is being looked at internationally and we are also preparing a report in the Parliament on this and other developments around which a consensus appears to be forming.

Already we are discovering some confusion between the dark pools run by exchanges and OTCs and some consider the fact that we have some 40% of trade unlit as a failure. Others while recognising the role of dark pools for large orders are nervous of lowering the waiver threshold, even though the reduction in average order size necessarily redefines 'large' at least in the relative sense, and therefore possibly also the market sensitivity sense too. Other threshold adjustment to waiver to encourage movement to lit venues is also proposed.

But if we assume, albeit with a few changes to achieve greater consistency and harmonisation, that MiFID does make a broad balance between the needs of individuals and markets, then I believe we can also assume that the equities regime should be extended to other equity-like instruments.

Going further, expansion to wider classes such as corporate bonds, structured finance products, CDS and other derivatives also seems appropriate. But then we must also recognise that pre trade regimes may need to differ, for example depending on whether such frequent pricing is relevant, as would not be the case for fixed income. Post trade we can and should aim for greater transparency in all classes, including a way to publish trades conducted away from exchanges and MTFs, and shortening delays for both regular and deferred post trade publication.

Crucially, and as a generality, we do *always* need to think what purpose is the transparency serving - to whom, for what and what kind of transparency. Is it for retail investors, professionals or regulators? Is it to aid price formation, or to underpin market integrity and how will it be used and interrogated?

One of the main reasons for prescribing transparency is for price formation and investor protection, and MiFID then leaves brokers free to choose where to go to get best execution – which of course is not always price. That assumption about best execution meaning price was made for the retail investor but for the professional investor it might also be speed or market impact or some other nuanced interest. In fact

I remember debating in the context of retail investment whether some ethical or environmental investment criterion would be challenged.

But whatever the basis of best execution, the question remains can it be supervised and is enough known. The feeling I have about the answer is that it needs more supervision, greater consistency and better implementation.

I am now already nudging towards the issue of competition, in the twilight zone not having quite left transparency.

We have already one example of where markets are being heavily constrained in the G20 decision for all derivatives to be traded electronically or on exchanges. This was I think a broad brush statement – if we analyse it too critically one could ask ‘are they really telling investors where to trade?’ Or ‘what is an organised venue’ and this will have to be defined. To me it seems that we must keep the flexibility of markets, otherwise at times of volatility they may migrate away, and it should not be too hard for us to remember that the main deliverer of damage in the financial crisis was an absence of market, the absence of willingness.

This means we should take care when looking at hybrids, like voice brokering facilitating electronic execution. Do we want to eliminate these or would that leave us with a market that is brittle instead of resilient. How far do we want such ideas to spread?

Looking at MiFID we should keep clear that its objective was more competition and protection, and we must be careful not to reverse engineer MiFID and come up with the wrong answers about its objectives. However not everywhere has applied MiFID in full and it is time to rectify this and examine waivers that allow Member States not to apply standards.

There has been movement from exchanges to MTFs and competition has increased. Prices have dropped although there are differing views over who has actually benefitted from that.

Partly in consequence of competition and partly through technological innovation there are now issues of fragmentation and new types of trading to consider. However MiFID did not say that we wanted to force trading into a specific format, nor should we now.

Some things are clear, that there is a strong case for aligning the organisational requirements of trading platforms, similar business means similar regulation. Other things are not quite so clear, like systematic internalisers and broker crossing networks. In committee, like others, we have discussed forcing broker crossing networks to become MTFs once a threshold is reached, but it is clear that proportionality plays an important part here, one solution to which is to have a relatively high threshold.

Since I have briefly strayed into proportionality, I will put a plug in here for portfolio managers who are a specific category but do not have specific rules in MiFID.

Now I come to the issue of technology and in particular high frequency and algorithmic trading and related issues of access. First I think that it should be clear that any tool can be abused, or indeed break down or bring unexpected consequences. That is not a reason to ban a tool but to look at ways to ensure resilience, including stress tests, and appropriate use.

I personally believe that with high speed of trading there is a strong case to move to systems allowing intra-day monitoring and interrogation about real time outstanding positions and leverage. I am also concerned about the issue of accessing faster and therefore better data because you can pay for it. I accept freedom to spend what you like on one's own IT and toolkit, but gaining differentiated access seems to me to cross the threshold of non-discrimination. There certainly need to be at least more safeguards, and again this is visited in the committee report including a ban on flash orders.

Orders that are systematically cancelled risk being market manipulation and therefore the review of the market abuse directive should take this and other behaviours and potential abuses including

algo-baiting into account. Hard coded algorithms need to have a fail safe mechanism and I query how compliance works with updates of strategies at increasingly frequent intervals.

It is often said that these tools have enabled better hedging and aim to remove the encumbrance of human reaction times: that causes me to ask who is thinking what they are doing anymore. So there are a lot of issues here which clearly need resolving but they are not unique to the EU and should also be tackled internationally.

Moving on now I am getting to the territory of data, unfinished business and consequences of competition, which means dealing with fragmentation and getting joined up

On the matter of unfinished business, we must have a consolidated tape. Post trade, this is the technological solution to fragmentation, an essential element in gaining full benefit from competition, and so the question is not whether but how.

Work by the market on common data standards is to be welcomed as is the recent announcement by regulated markets that they will unbundle their pre and post trade data. But progress overall is painfully slow. We really must have coordination and some regulatory intervention seems inevitable to push firmly on the outstanding barriers to make sure that it gets done in a sufficiently rapid timeframe. The skill and knowledge for such a project is in the industry and I would say it is in their interests to get on with it before a not-for-profit solution is imposed.

I will now come to a matter of joined up thinking, and action, over financial and physical markets. This is something I have promoted for quite some time and so I do welcome the Commissioner's moves towards coordination. I have doubts about whether we can in fact get all of this addressed through or with MiFID, but certainly it is appropriate to take it into consideration and move forwards.

Just because we have these issues spread over different regulators, different commissioners and DGs and different committees in the

Parliament does not mean they are so separated in the investor world, although there are issues of different organisation and proportionality that must not be overlooked.

Nevertheless, as I have said before, regulators need to be able to look at the same and complete data and to interrogate it looking for cross linkages. So we need the means for surveillance and the tools to analyse what is going on. This means better data capture and cooperation, and certainly not a turf war.

The building of tools for data interrogation is vitally important both in this wider joined up framework and elsewhere, for we are certainly heading in the direction of swimming in data, collection of which is a costly exercise. However it is not the collection of data that renders markets safer and policeable, it is the interrogation and analysis of the data.

There must be opportunities for joint efforts internationally and we will already be facing up to this in EMIR with regard to repositories. For the EU there will also be some data protection issues.

So that is a big challenge, ultimately to establish data that can be readily consolidated, without duplication and without gaps, together with the ability to analyse across asset classes, both financial and physical.

Once again this begs the question of who should do it, private sector or utility, but since the capture and analysis process must have the ability and competence to follow market developments the private sector has a significant part to play.

We have already ventured towards cost based pricing in EMIR and repositories, but this does not mean that is always the solution – indeed we should tread with care or before long we will find the EU is one big public utility - which does not quite fit with the competition ethos of the single market and causes me to worry over moral hazard and systemic risk.

Finally what about position limits and other circuit breakers?

Theoretically these are attractive but they also carry risk of being too crude or too inflexible particularly if fixed by legislation that is lengthy and complex to change.

In the new supervisory architecture we will have an extra dimension to achieve cross border coordination but extra care needs to be taken to make sure that decisions are still made responsively, from knowledge and understanding, which means close to the markets. A bad decision is not made better by making it widespread!

To conclude, Commissioner, as ever MiFID does not stand alone it links into several other pieces of legislation being newly made and under review. It is vitally important that we continue to look at the big picture and the collective impact of our work, for as I said at the start jobs, pensions and member state deficits will be affected.