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European Regulation
A Tale in Four Acts

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According to the Chinese calendar 2012 is the Year of the Dragon. But if you ask anyone in financial markets, 2012 is the year of the regulator. The current influx of drafts, proposals, consultations, regulations and technical standards is enormous. So much so that it prompted seven of Europe's most influential trade associations to voice their concerns in an open letter to the European Commission. But it is not only the industry that is suffering under the burden; the regulators are feeling the strain too. Members of the European Parliament's Economic and Monetary Affairs Committee recently tabled thousands of amendments with respect to the Markets in Financial Instruments Directive (MiFID) II and the Market Abuse Directive (MAD) II – that's plenty of bedtime reading material for years to come.

This paper examines the key regulations affecting the European financial markets and looks at how they interrelate and their impact on market structure.

Act I: Many good intentions

The characters in the tale of European regulation are many and diverse. One leading player is the European Securities and Markets Authority (ESMA), the supra-national organisation in which Europe's national regulators (the UK's Financial Service Authority (FSA), Germany's Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin), among others) are represented. Also looming large are the political forces represented by the European Commission, the European Council and the European Parliament, the institutions in charge of the legislative process.

The plot stretches across two key battlefields: first, directives, or legislative acts by the European Union (EU) that require individual member states to pass a law to achieve a particular result; second, regulations, which in contrast come into effect immedately without member states' action. The difference reflects the epic battle between centralist governance out of Brussels and the respective European national governments wanting to protect their own interests. Without giving away the ending of this tale, upcoming laws will provide Brussels with considerably more power (via new regulations) than it has at present.

The current flood of regulation is not a well-orchestrated master plan that co-ordinates all regulatory actions in 2012, but rather the product of numerous independent developments which have taken place in recent years (see Figure 1), and which will influence our steps on the road ahead (see Figure 2).

European Market Infrastructure Regulation (EMIR)

In the aftermath of the financial crisis of 2008 and the collapse of Lehman Brothers, the world realised that it needed to tighten up financial regulation. Off the back of the subsequent G20 meeting, global leaders decided it was time to move the gigantic over the counter (OTC) derivatives market out of the wings and into the spotlight. This led to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), currently being discussed in the US, and the casting of its co-star, EMIR, which introduced a clearing obligation for 'eligible' OTC derivatives and extensive regulation around central counterparties (CCPs) and trade repositories.

Markets in Financial Instruments Directive and Regulation (MiFID, MiFID II and MiFIR)

MiFID was enacted in 2007 under EU law in order to harmonise regulation for investment services across Europe. Broadly speaking, it covered investment research, conflicts of interest, best execution and client categorisation.

When MiFID came into effect it had already been decided that a review would take place three years later. That review process - MiFID II - started in 2010 with a consultation by the European Commission and the results are currently being debated by the European Parliament and Council.

MiFID, as it says in the name, is a directive which was implemented by each member state separately. As part of the review process some of the directive will be converted into regulation. The obvious advantage is that regulation is more effective when ensuring a level playing field across Europe, but, as the plot thickens, we now have to deal with both MiFID II and MiFIR. It is not yet confirmed when the new regulation will come into effect, but it will most likely be sometime in 2015.

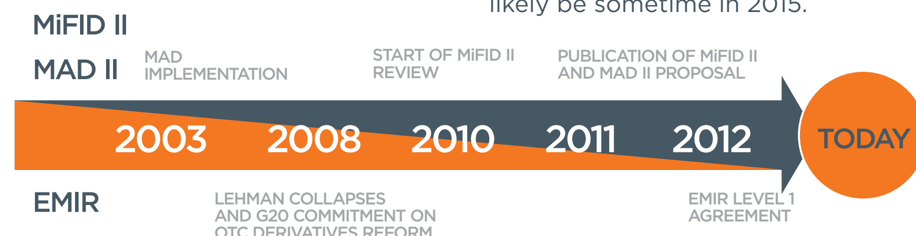

Figure 1: Regulation – where have we come from?

Figure 2: Regulation – where are we going to?

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Market Abuse Directive and Regulation (MAD II)

Under MAD there are a number of compliance checks that have to be carried out and which can be broken down into three categories: (1) insider dealing checks; (2) DMA market abuse checks; and (3) principal dealing checks.

In October 2011 the European Commission published its long-awaited proposal for new EU laws to update the existing MAD. Similar to MiFID II, MAD II is also split into a directive (MAD II) and regulation (MAR). MAR and MAD II are being debated in the European Parliament in parallel with MiFID II, so it is expected that the new rules will apply on the same date.

Act II: Daily politics hijack the agenda

It is widely agreed that regulatory overhaul is necessary so that European markets can remain competitive in the future. Unfortunately, these good intentions are easily hijacked by topics that are clearly driven by short-term thinking and do not contribute to the larger agenda. It should be noted, too, that the current round of regulation reflects a shift in emphasis away from the creation of a level playing field, towards ensuring the safety and resilience of the markets.

Attempts to restrict technology

On 6th May 2010 the Flash Crash caused the Dow Jones Industrial Average to plunge by more than 1,000 points (approximately 9%) only to recover those losses within minutes. The public and press quickly (and wrongly) identified high-frequency traders as the villains of the piece. While the debate on the cause of the Flash Crash and the impact of high-frequency trading (HFT) on financial markets is far from concluded, regulators and politicians decided that it was about time they put the brakes on those IT-savvy traders. Hence measures such as a minimum resting time or a market-making obligation for all HFT firms are being proposed by the European Parliament in the latest MiFID II draft. This sounds very much like an attempt to ban technology from financial markets. Technology drives innovation, and sometimes innovation creates new problems, but the answer should never be to ban technology. Let's hope that this tale does not become a medieval tragedy in which the HFT community seeks bloody revenge on the regulators and pursues its business objectives abroad.

Attempts to restrict falling prices

In the midst of the financial crisis, in the autumn of 2008, European regulators decided to protect financial institutions by imposing a ban on short selling in financial shares. Politicians might have reasoned that prices fall when people sell, so that restricting the selling of shares would lead to more stable prices. Unfortunately they were very much mistaken and, once again, we're reminded that regulators should focus on regulating markets and not prices. Theoretical and empirical studies by academics show, overwhelmingly, that short selling bans of any kind consistently hurt market efficiency and increase short-term volatility. In effect, a short selling ban in itself may cause the next asset price bubble[1] After a number of national short selling bans, we are now facing a Europe-wide regulation on short selling from November 2012. Looking on the bright side, at least something has improved within the last three years; regulators have stopped implementing bans overnight. Now, at least, market participants have some time to implement regulatory changes into their operations.

Attempts to restrict trading

The latest regulatory 'innovation' is a proposed European financial transaction tax, or 'Tobin Tax'. Since governments have had to bail out numerous financial institutions, the argument goes, it is only fair that the financial industry as a whole should contribute to the recovery by paying a tax. But again, politicians are seriously misguided on this issue and it is highly unlikely that a financial transaction tax will change the behaviour that led to the collapse of Lehman Brothers. Instead, any such tax would be financed by those who had nothing to do with the financial crisis. We must understand that a financial transaction tax is just another cost component to trading. From a bank's perspective nothing much changes, except that its clients may very well trade less as a result of the higher costs. But, if all intermediaries were to pass these additional costs on, everyone who trades securities would eventually pay the price. Ultimately, that includes everyone who is investing in some way. Not only would end investors have to cover these costs themselves but they would also miss out on the interest they might have earned if the tax monies had been invested.

An exemption for pension funds or market makers might look like a good remedy, but only half-heartedly addresses the underlying issue. It's also hard to imagine that HFT firms will qualify under any exemption given the current tenor of public opinion towards them. You can say what you like about HFT firms - and you may even argue that they caused the Flash Crash in the US - but surely everyone can agree that they cannot be held responsible for the collapse of Lehman or for the need for government bail-outs to secure the futures of Freddie Mac, Fannie Mae and Northern Rock. After all, HFT firms usually have a flat position at the end of the day.

While it is still unclear which countries will adopt a financial transaction tax, and regardless of how many exemptions are defined, it is almost certain that the intended results will not be delivered. Large professional businesses will invest a great deal of time and money to work out how to take advantage of any exemptions, while the small retail traders will be caught in a web of new complex regulations.

Act III: European market structure in 2016

Assuming that most of the regulation currently under discussion will be implemented by 2015, what exactly will the European markets look like in 2016?

Multi-asset regulation

MiFID was initially aimed firmly at equities trading. Now MiFID II takes a step towards becoming a truly multi-asset regulatory framework (see Figure 3), a move that will have a particular impact on the regulations regarding transparency. Some asset classes are traded very differently from equities and the framework must have the flexibility to support this heterogeneity. MiFID II captures

[1] For an overview on academic studies relating to short selling see Alessandro Baber and Marco Pagano (2012): Short-Selling Bans around the World: Evidence from the 2007 – 2009 Crisis, Journal of Finance, Forthcoming.

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the low-hanging fruit by extending the scope from equities to include equity-like products such as exchange traded funds (ETFs), depository receipts and contracts for difference (CFDs). All these products will be subject to the same transparency regulations as standard equities are today. In a second step, MiFID II will also shine a spotlight on non-equity instruments, where it subsumes everything from derivatives to bonds.

In both groups (equities and non-equities) the proposed regulations stipulate that you must provide pre- and post-trade transparency. But you can apply for a waiver. For equities the existing waivers do not change materially but, for any trading activity in equity-like instruments that are not compliant with MiFID today, changes will need to be implemented for MiFID II. This is not necessarily true for non-equities. Non-equity products may apply for a pre-trade transparency waiver based on the liquidity level and trading activity in that product. So far, ESMA has not defined how low the level of liquidity must be in order to qualify for this waiver, nor have they explained what they define as a product, so there is still some room to manoeuvre and address the concerns of market practitioners about overly strict transparency regulation.

In contrast, EMIR focuses solely on derivatives with rules covering clearing obligations for OTC derivatives, common rules for CCPs and for trade repositories and rules on the establishment of CCP interoperability. Given that it deals with clearing obligations and counterparty risk, it's clearly less relevant for cash products. After all, the counterparty risk in cash products is just a couple of days until delivery.

MAD II regulation will be the most multi-asset of them all. In scope for MAD II will be all instruments traded on regulated markets (RMs), multilateral trading facilities (MTFs) or organised trading facilities (OTFs) including all instruments that are related to them or traded OTC. So we can expect to see MAD II applied consistently across all asset classes.

What will happen to OTFs?

OTFs are the new characters entering stage left, designed for moving the large OTC market onto some form of regulated trading platform. So far it is hard to predict whether OTFs will join MTFs as star performers or are destined to lead a bit-part existence alongside systematic internalisers. One thing that is certain, though, is that OTFs will differ vastly for equities and derivatives. A white paper by the Association for Financial Markets in Europe (AFME)[2] explored the composition of the reported OTC volumes in European equity markets. These figures can be used to forecast the potential market share for OTFs in those particular markets (see Encore). This analysis (see Figure 4) shows that OTFs would capture no more than 10% of the market, leaving RMs and MTFs as the dominant venue types.

This is in stark contrast to the derivatives marketplace. A recent paper by the International Swaps and Derivatives Association (ISDA)[3] provides some insight into how interest rate swaps (the largest group of derivatives) are traded today. This analysis clearly shows that most volume in these instruments is traded in a way that is not compatible with RMs or MTFs. So, depending on what ESMA deems 'eligible' for clearing, up to 94% of the notional amount could go through OTFs and they could well take centre stage in a grand production (derivatives), while remaining a more obscure supporting act in fringe theatre (equities). Some politicians and practitioners are already considering restricting OTFs to derivatives, as shown in the latest MiFID II draft issued by the European Parliament and Council.

It might be true that AFME and ISDA each have their own story to tell but, regardless of how you twist and turn the statistics, the bottom line remains: interest rate swaps differ vastly from equities and therefore require a different market structure.

Act IV: Unintended consequences

Current proposed regulatory changes are massive and will alter the face of the financial industry for many years to come. As with any project of size there is always the risk of unintended consequences.

EMIR will require that many more derivatives trades should be centrally cleared. This implies that investors will have to put up much more collateral and will be more concerned about its efficient use. In order to make the best use of collateral investors want to net as much as possible by using the same margin pools. There will be a strong tendency, therefore, to consolidate with a few very large CCPs. Yes, the CCPs will be safe and tightly regulated, but how operationally efficient will they be once the market is allocated across them?

MiFID brought fragmentation of liquidity to the European markets when it became possible to trade the

	MiFID II	EMIR	MAD II
Equities ETFs Depository Receipts Certificates Other Equity-like Products	**RM, MTF and OTF** *Pre- and post-trade transparency with the existing waivers:* - Reference price - Negotiated trade - Order management facility - Large in scale **OTC** *Existing post-trade transparency.*	No change.	Scope of MAD includes all instruments traded on a RM, MTF or OTF, and all related instruments traded OTC.
Bonds Structured Finance Products Derivatives - Interest Rate Swaps - Interest Rate Contracts - FX - CDS - Currency Swaps - Equity-linked - Commodity	*As above but allows for additional waivers for pre-trade transparency due to:* - Trading activity - Liquidity	No change. (Bonds, Structured Finance Products) Clearing obligations for eligible derivatives, as defined by ESMA. However, there is uncertainty about how ESMA will group derivatives. (Derivatives)	

Figure 3: Potential regulatory Framework across asset classes in 2016

[2]Association for Financial Markets in Europe (AFME): Market Analysis: The Nature and Scale of OTC Equity Trading in Europe, April 2011.
[3]International Swaps and Derivatives Association (ISDA): MiFID/MiFIR and Transparency for OTC Derivatives, February 2012.

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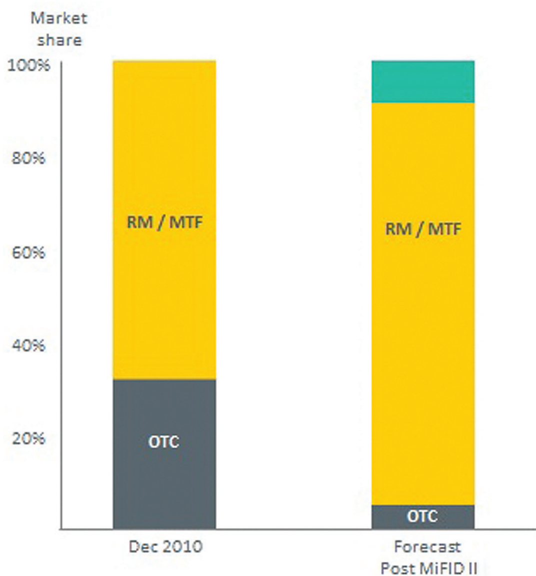
same stock at multiple venues. MiFID II will go a step further into multi-asset Europe. As cash equities become increasingly tangled up in regulation, investors will look to options, futures, ETFs or CFDs in order to gain the same economic exposure to the markets. This asset class fragmentation raises some interesting issues, not least around execution quality as investors may end up trading instruments that span very different best execution policies. The question is will the regulators be able to keep up? It remains to be seen if this scenario will play out as a consequence of MiFID II, or whether we'll see greater consolidation as a result of the increased demand in collateral requirements under EMIR. In the final analysis, the added benefits of fragmentation need to outweigh the extra costs of clearing.

Finale

Regardless of the outcome, overly strict or onerous regulation will naturally create an incentive to search for loopholes. Whether it is a newly designed product that falls outside the regulatory framework or a move to trade outside the EU, the potential will always exist in a global multi-asset world to circumvent unnecessarily onerous regulation. After all, history has taught us that markets can innovate faster than politicians can pass new laws.

A careful balance between tight regulation and common sense must be found if there is to be a happy ending to this tale.

As with any great drama, whatever the critics' assessment may be, audiences will remain gripped for many years to come as this complex tale unfolds. Whether the regulators ultimately receive a standing ovation or catcalls from the stalls remains to be seen. Either way, this is certain to be one of the longest running dramas to be played out on Europe's financial stage.



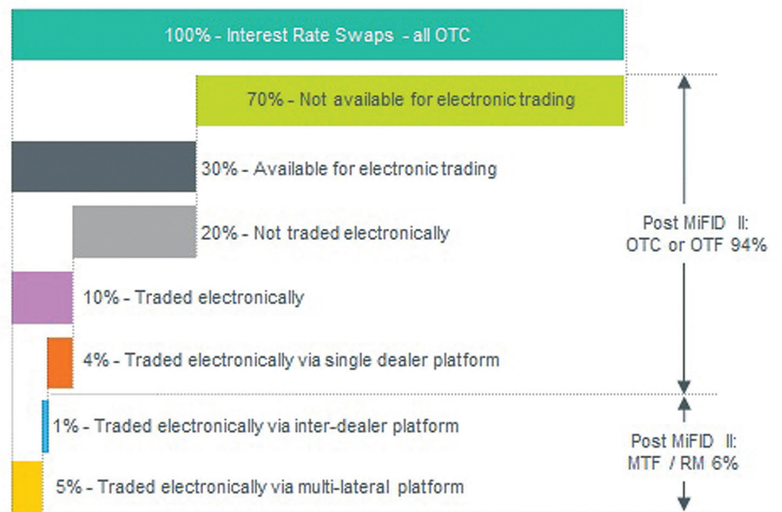


Figure 4: Market potential for OTFs vs. RMs and MTFs in Europe

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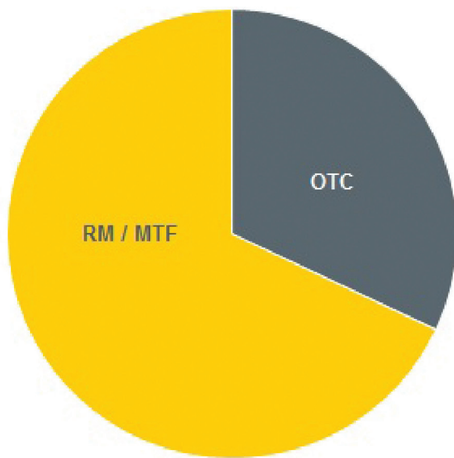
Encore

European Equity Turnover in Q3 2010*

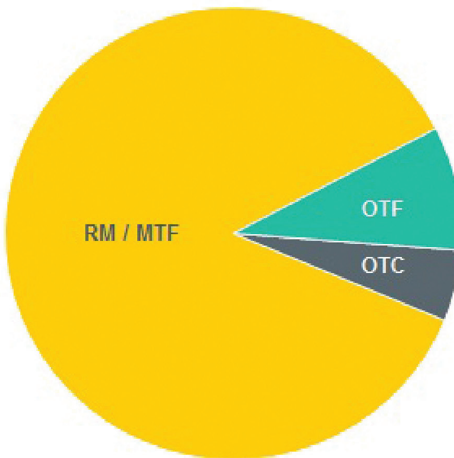


Description

- Equity turnover in Europe can be traded via RM, MTF or OTC
- AFME published a white paper in April 2011 analysing the nature and scale of OTC equity trading in Europe*
- The aim of this paper was to provide insight into the OTC figures
- Based on a survey among its members, AFME classified OTC trades in the following categories:
  - Broker to Broker Give-Up/Give-In;
  - Other Agency and Riskless Principal;
  - Broker to Broker Non-Give-Up/Give-In;
  - Other Principal Trades on Behalf of Clients;
  - Crossing Processes/Systems; and
  - Systematic Internaliser
- AFME employed that data to estimate how much OTC volume is likely to be double reported

*Source: AFME, Market Analysis, The Nature and Scale of OTC Equity Trading in Europe, April 2011

Post MiFID II Equity Turnover Distribution



Description

Assumptions:

- AFME classified the two categories 'Broker to Broker Give-Up/Give-In' and 'Other Principal Trades on Behalf of Clients' as OTC reporting events. They can be ignored because they consist only of double reporting.
- The category 'Crossing Processes/Systems' shifts 100% to OTF. It has been suggested that OTFs will be the regulatory framework for broker crossing networks (BCNs). Thus, it is assumed that 100% will shift to OTFs. However, this assumption ignores that BCNs might match agency orders against proprietary capital. That will not be possible in an OTF. But, since the aim of this analysis is to estimate the maximum market share feasible, we (knowingly) overestimate the OTF market share.
- 50% of category 'Broker to Broker Non-Give-Up/Give-In' and category 'Other Agency and Riskless Principal' shifts to OTF. Once again, the assumption reflects the maximum amount that seems feasible to shift into OTFs. The restriction by OTFs to not match against proprietary capital might reduce that potential even further.
- For simplicity, no additional turnover transfer between RM, MTF, OTF or SI is assumed

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