Amafi
Association française des marchés financiers

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Revisiting MiFID

Editorial

Two decades ago our association published a report on how the stock exchange can and should serve the economy as a whole. Today that report is more relevant than ever. It argues that the equity market is vital to business financing and explains what needs to be done to encourage it. Channelling savings into companies and strengthening their capital base has become a critical issue that cannot be set aside.

In his closing address to a financial industry convention at the end of March, President Sarkozy took a determined stance, calling on the finance minister to come up with proposals for "a new tax framework that provides a strong incentive to direct savings towards corporate equity financing".

Amafi plans to play an active part in this project - and not solely from a tax perspective - especially since it is related to two other key issues. First and foremost, the savings set aside for pension purposes need to be exposed to the real economy. The second issue concerns the ability of Paris to assert itself as the leading financial centre in the euro zone and thus respond to the expectations of our countrymen. In an opinion poll published in *Le Monde* in mid-January a full 90 per cent of respondents said that Paris's position as a top-flight marketplace was fairly important or very important for the French economy.

Philippe Tibi
Amafi Chairman

Feature


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Hailed as a regulation that would forever change share trading in Europe, the Markets in Financial Instruments Directive (MiFID) is up for review this year. While most market participants accept that MiFID needs overhauling, they do not always agree on what needs to be fixed. We explore the pros and cons of this pioneering directive and outline Amafi's contribution to the debate.

MiFID was enacted in 2007 to create a deep, efficient and integrated stock market in Europe. The new regime was to encourage consumers to invest in shares for their retirement, ultimately easing the burden on overstretched government finances. In a nutshell, MiFID was an upgraded version of the Investment Services Directive promising more competition, greater transparency, lower costs and stronger investor protection.

But crafting a one-size-fits-all framework was always going to be a tough proposition, especially since the directive was short on specifics and gave member states a fair amount of leeway for interpretation.

Feature

As a result, criticisms and complaints have been mounting for the past three years and there now seems to be a widespread feeling that MiFID's drawbacks may outweigh its benefits. That is why the review currently underway at the European Commission is a timely opportunity for all stakeholders, including member states and industry groups, to analyse the true impact of the directive and plan the way forward. It will also offer the chance to apply the lessons learned from the financial crisis.

In 2009 French Finance Minister Christine Lagarde commissioned a working group headed by Pierre Fleuriot, president of Credit Suisse France, to examine key aspects of the review. Amafi, which played an active part in preparations for the adoption and transposition of the directive, submitted a set of proposals that are largely echoed in the group's final report, published this February (see box).

Miffed with MiFID?

The picture is not entirely negative. MiFID ended the de facto monopoly of big national stock exchanges and allowed smaller, nimbler rivals with more efficient platforms to emerge. The arrival of these multilateral trading facilities (MTFs) and new clearinghouses has brought down trading and clearing costs, reduced spreads and facilitated pan-European trading. Meanwhile technology-driven innovation has fostered developments such as smart order routing and high-frequency trading. And investment firms are now required to obtain more detailed information on clients to ensure that their products and services are suited to the person's investment aims and level of market knowledge.
But three years on, despite these achievements, it seems that the aim set out in the draft version of MiFID, namely to promote an "efficient, transparent and integrated trading infrastructure", has not been totally fulfilled. What's more, the unintended consequences of the new regime – in equity markets at least – may be penalising the intended beneficiaries: issuers and investors.

Competition is undeniably keener than in the pre-MiFID era, but it is concentrated on the most heavily traded stocks. Despite their rivalry, MTFs and regulated markets are commercial enterprises that need to maximise revenues, so they have focused on those clients that deliver the largest volumes, especially high-frequency traders and hedge funds. More significantly, MTFs rely on aggressive but loss-making business models that do not always cover their costs. As a result, some of these venues are struggling and are likely to be bought up…by stock exchanges. For example the London Stock Exchange has acquired 60 per cent of Turquoise and merged it with its own platform, Baikal. If this trend gathers momentum, the market structure may well end up where it started!

Another of MiFID's much-vaunted benefits is cost reduction. According to a report from the Committee of European Securities Regulators, the new rules have "put downward pressure on direct execution costs". That said, the benefits are not equally divided. Trading venues and clearinghouses may have reduced their fees, but the main beneficiaries of those cuts are very large firms or "liquidity providers". It is also doubtful whether issuers have seen a decline in the cost of financing, although hard evidence is lacking at this stage.
Investors, too, have the feeling that costs have not come down. This is because the decline in unit costs has not offset the increases caused by the need for multiple executions on multiple exchanges in order to fill certain orders. In addition, market participants have incurred substantial expenditure to comply with MiFID requirements, particularly the acquisition of costly systems to detect the best execution venues, and they have yet to recoup their investments. Last but not least, the cost of market data has soared because of the vast amount of information to be consolidated. In all, according to Emmanuel de Fournoux, Director of Market Infrastructures and Prudential Regulation at Amafi (see Q&A), overall costs actually stayed the same or rose slightly between 2007 and 2010.

One of the major criticisms levelled at MiFID is that liquidity, the lubricant of efficient markets, has been fragmented, not enhanced, by competition. Moreover the vast majority – possibly more than 70 per cent — of the liquidity present on trading platforms is due to proprietary trading. Some contend that this is a positive development and that high frequency traders, hedge funds and the like improve market efficiency and narrow price spreads. Others argue that many of these transactions take place in very short timeframes, meaning

WHAT AMAFI PROPOSES

In its contribution to the Fleuriot report on the MiFID review, Amafi made two overarching proposals, broken down into key actions:

Make an objective analysis based on concrete data

- Define liquidity
- Scrutinise some of the technical developments
- Sketch the future market landscape
- Determine investors' and issuers' current and future expectations

Determine a market structure for the financial community as a whole

- Strengthen post-trade and pre-trade transparency requirements
- Ensure equal treatment of investors
- Implement efficient clearing and settlement systems

Feature

that the liquidity extracted from the market is merely shifted: it returns very quickly, possibly several times, but at a different price that includes the participant's profit margin.

Going dark

Transparency, especially in terms of data and price formation, was also a MiFID leitmotif. That goal may have been compromised to some extent by, among other things, the apparent growth in over-the-counter trading and the emergence of alternative trading platforms such as automated crossing networks or "dark pools". These alternative systems, which offer anonymous execution and lack a quote display, are not bound by MiFID's pre-trade transparency requirements and may therefore undermine efficient price formation. The jury is still out on this issue, though. Critics say these systems impair overall liquidity and price formation quality because they do not interact with other orders. Their supporters, however, consider that they serve clients' interests.

Whatever the pros and cons of MiFID, what is certain is that investors have yet to reap – or perceive – the benefits. This may be due simply to a lack of clarity and explanation (for example, a report from the UK Financial Services Authority found that the information provided by firms about their execution policies was skimpy and vague) or to the fact that the real benefits have yet to materialise.

Back to basics

The review will focus on issues such as trading data, large-scale orders, commodity derivatives and, possibly, bond and foreign exchange markets. But to respond to growing discontent sparked by the feeling that the market has become less transparent and that the interests of issuers and investors have been eclipsed by those of liquidity providers and other big players, the Commission needs to address a number of more basic questions. For example unless alternative trading platforms are subject to tighter regulation, the playing field will become increasingly uneven, thereby undermining the reliability of price formation. In the words of Christine Lagarde, "Without harmonisation, competition could adversely affect market stability".

Another crucial issue is the transparency of post-trade data. One possible solution to the problem of fragmentation and spiralling costs is the creation of a European consolidated tape, an integrated system of trading data similar to the one that exists in the United States, which could be run by an entity under the supervision of the future European Securities and Markets Authority.

The efficiency of post-trade infrastructures will be addressed through the forthcoming European Market Infrastructure Legislation package, but it is inextricably linked to the MiFID review because the lack of integration of post-trade infrastructures has a direct impact on the market environment.

But possibly the most fundamental question concerns the very purpose of financial markets. They do not exist simply for the benefit of investment services providers and blue-chip corporations but to contribute to the financing of our economies. Small and midsized firms, the bedrock of Europe's economic growth, need easier and cheaper access to the markets, particularly since forthcoming prudential regulations may make banks more reluctant to lend to them. And individual investors have yet to be convinced that direct investment in equities is the best way to save for the future. Will the MiFID review tackle these basic problems or will it fail to grasp the big picture?

Anthony Bulger

Q&A with…

Emmanuel de Fournoux, Director of Market Infrastructures and Prudential Regulation, Amafi

How does Amafi analyse the existing situation?

One of our biggest problems is a lack of hard data and academic research. Amafi represents a broad constituency, from small agency brokers to big multinational firms. Our members have differing views on certain issues, such as high-frequency trading, and there are no hard and fast answers as yet. At present, the debate seems to be informed more by gut reaction than by in-depth analysis of objective data.

In your view, what is the crux of the review?

Broadly MiFID deals with two things: the functioning of investment services providers and the functioning of markets. The review really must concentrate on the second aspect, even though it is mind-bogglingly complex, rather than the first, which is less urgent. If that is not the case, then investors will lose out.

What should the Commission do?

Listen carefully to issuers and investors. Markets do not exist solely for the benefit of banks and brokers but to allow companies to raise equity and contribute to economic growth. In short they play a social role.

News

Europe

Major shareholding notifications

CESR launched a consultation on proposals to extend major shareholding notifications to "instruments of similar economic effect to holding shares and entitlements to acquire shares". Responding, the Amafi Major Holdings Group pointed to the needlessly short seven-week consultation period. Above all, however, it emphasised the singular nature of a consultation paper that not only ignores the work done by the European Securities Markets Experts (ESME) Group on this issue at the behest of the European Commission but also expresses strong, unqualified backing for a position adopted by just one member state *(AMAFI / 10-16)*.

The search for greater transparency in financial instruments is certainly warranted. But to achieve maximum Europe-wide harmonisation – a goal Amafi strongly supports – it is necessary to seek a balanced solution that delivers a relevant outcome. Amafi therefore endorses the position recommended by ESME, namely to separately report significant positions in the instruments concerned (which generally do not give access to voting rights) rather than treating them as if they were shareholdings or voting rights.

Sylvie Dariosecq, Marie Thévenot

Amendments to the Prospectus Directive

The European Commission held a consultation in March 2009 on proposed amendments to the Prospectus Directive. *(AMAFI / 09-18)*. Several of the proposals have since been incorporated into a revised draft directive for submission to the European Parliament. The amended text is due to be adopted by the summer. Amafi's Corporate Finance Committee is monitoring these developments.

Sylvie Dariosecq

Post-trade directives

The European Commission has initiated a debate on how to regulate post-trade activities. Regulation has become a key aim for the Commission, which is learning lessons both from the financial crisis and from the failure of the prevailing free-market ethos epitomised by the Code of Conduct on Clearing and Settlement. Two European statutes are currently in preparation: legislation on market infrastructures and over-the-counter derivatives markets, and the Securities Law Directive. Despite major shortcomings in both texts, Amafi considers that the Commission's change of stance on this issue is a major and necessary step forward for the integration and security of Europe's financial markets.

Emmanuel de Fournoux

News

France

Bringing midcaps to market

As part of government-led discussions on fundraising by medium sized companies, a working group was set up in November 2009 under the umbrella of the Directorate General of the Treasury and Monetary Policy to make near-term proposals on independent investment research. Amafi's representative on the group is Eric Le Boulch, a member of its executive board and chairman of CM-CIC Securities.
Amafi contributed a paper *(AMAFI / 10-07)* explaining that midcaps' access to market financing was hindered by not one but a whole range of factors, which cannot be solved merely by ensuring that independent research is economically viable. The entire ecosystem needs to be revitalised through a series of measures. Two of the main measures emphasised by Amafi are to grow long-term savings in order to channel funds to midcap stocks (see Editorial) and to bring in rules tailored specifically to small and midsized companies, as the finance ministry has said it intends to do.

Emmanuel de Fournoux

Transposition of the Capital Requirements Directive

The ACP has asked industry groups to take part in work on transposing the three EU directives (2009/27/EC, 2009/83/EC and 2009/111/EC) that supplement the directives on capital requirements (2006/48/EC and 2006/49/EC) – the so-called CRD 2 Package. In addition to measures to regulate variable compensation, which are similar to those contained in CRBF Regulation 97-02, the directives have three main thrusts: large exposures, securitisation and the definition of capital. The package is due to come into force on 31 December 2010 and Amafi is playing a major part in the transposition work, alongside those of its members directly concerned by the new regulations.
Amafi is also taking part in the calibration exercise organised by the Basel Committee to determine how the new standards it is currently debating will affect capital adequacy.

Emmanuel de Fournoux

ACP: a new supervisory authority

Autorité de Contrôle Prudentiel (ACP), a new supervisory authority, came into being officially on 9 March 2010 when its board met for the first time. The creation of the ACP was prompted by the Economic Modernisation Act, passed in August 2008, which allowed the government to reform the oversight of the banking and insurance industries. The ACP takes over the duties and obligations of its predecessors – Commission Bancaire (banking), ACAM (insurance and mutuals), CECEI (investment firms and credit institutions) and CEA (insurance) – notably their contractual and international commitments.

Sylvie Dariosecq

Anti-money laundering and terrorism financing

Commission Bancaire instruction on branches

Following recent amendments to CRBF Regulation 97-02, branches of investment firms headquartered in the European Economic Area are now subject to the provisions on anti-money laundering and counter-terrorist financing (AML/CTF). In particular they are required to prepare a report on their internal control procedures for AML/CTF and submit it to the ACP before 30 April each year. The report's contents will be specified in a Commission Bancaire instruction in the near future.

Financial Action Task Force (FATF)

Responding to a call by the G-20 summit in London last April, FATF has brought in new procedures to identify countries and jurisdictions considered to be high risk and non-cooperative in terms of AML/CTF. It has published two lists to identify jurisdictions that have strategic AML/CTF deficiencies. France's financial intelligence unit, Tracfin, has reminded firms that they must factor this information into their risk-based approach.
The International Council of Securities Associations (ICSA), of which Amafi is a founder-member, wrote to FATF in February expressing disappointment at the typology set out in "Money Laundering and Terrorist Financing in the Securities Sector", a report issued in October 2009. The typology chiefly concerns brokers dealing with retail investors and those that maintain custody accounts, so it is hardly representative of the AML/CTF risks inherent in the activities of the members of the securities associations belonging to ICSA. In its letter, ICSA urged FATF to draw up a typology appropriate to wholesale activities.

Stéphanie Hubert, Marie Thévenot

News

Taxation

Bonus tax

An exceptional tax on bonuses awarded in 2009 has been written into the 2010 Additional Budget Act. After an extensive parliamentary debate, only two aspects of the government's initial plan were amended. Amafi has issued a comment paper *(AMAFI / 10-15)* on this topic.

Technical aspects aside, the tax sends a negative signal to the French financial community, particularly since the only other country mulling a similar measure, the UK, is far from moving to the adoption stage. Amafi's chief executive commented expressly on this aspect of the legislation in an article published on the website of *Les Echos* (www.lesechos.fr, "Faire payer les financiers, encore faut-il savoir à quoi cela sert!")

Eric Vacher

Presentation of the VAT Package in London

Amafi organised two presentations in London in early March for the Investment Management Association (IMA) and the Association of Financial Markets in Europe (AFME) to explain how France has transposed the VAT Package. The key issues addressed were the place of supply rules for VAT on services and their consequences for financial market professionals.

The presentation to the IMA concentrated on the comparative advantage enjoyed by French brokers – and indirectly by their European clients, especially those in the UK – because of differences in countries' VAT regimes for financial transactions. Execution, analysis and advisory services sourced by B2B clients from French-based providers are generally more competitive than those purchased in the UK or other member states because they are not liable to VAT, pursuant to EU place of supply rules. Moreover, clients are entitled to recover "input VAT" on their purchases from the French provider. Regarding commission sharing arrangements, the presentation showed that the French regime allows UK asset managers to purchase execution and research services from French brokers within a secure and operational framework.

The meeting with AFME provided an opportunity for a broader review of various tax issues. In addition to France's transposition of the VAT Package and an explanation of the rulings issued by the French tax authorities in order to clarify the scope of the VAT option on financial transactions, the presentation also covered the VAT regime for transactions in over-the-counter derivatives and commodities, the draft directive on VAT treatment of carbon trading, and the implementation of commission sharing arrangements by France and the UK.

The significance of Amafi's initiative was highlighted by the lively discussions that followed each of the presentations.

Eric Vacher, Emmanuel de Fournoux, Véronique Donnadieu

Amafi Highlights

Commissions & Working Groups

Stéphane Pellerin appointed Chair of the Commodities Committee

Stéphane Pellerin, Chief Operating Officer of BNP Paribas CIB - Commodities Derivatives in London, was appointed chair of Amafi's Commodities Committee in early March. He takes over from Bertrand Meyer, whose valuable contribution was acknowledged by the entire committee.
To monitor ongoing work on the organisation and development of the CO_2 market, the Commodities Committee has set up a Carbon Group composed of members involved in these issues. Amafi is thus playing an active part in the work of the Carbon Finance Committee formed by Paris Europlace, and in the commission chaired by former AMF chairman Michel Prada as part of the market advisory group on carbon trading.

Dominique Depras

New Members

European Equities SAS, an investment firm providing order reception/transmission services and investment advice to institutional clients for equities and bonds. The senior executives are Philippe Barroso (Chairman) and Bertrand Paillère (CEO)

Finaveo et associés, an investment firm providing order reception/transmission services to professional and retail investors. The senior executives are Axel Rason (Chairman and CEO), Alexandre Peschet, Pascal Vieville and Franck Fourrière (Deputy CEOs).

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AMAFI documents quoted in this Newsletter and flagged with a reference number are on our website at
www.amafi.fr
Most of them, notably AMAFI's responses to public consultations, are freely available, but some are restricted to members only.

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