Swiss Finance Council

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Solving a Capital Market Puzzle with Transatlantic Experts

KPMG Luxembourg & ISEEE

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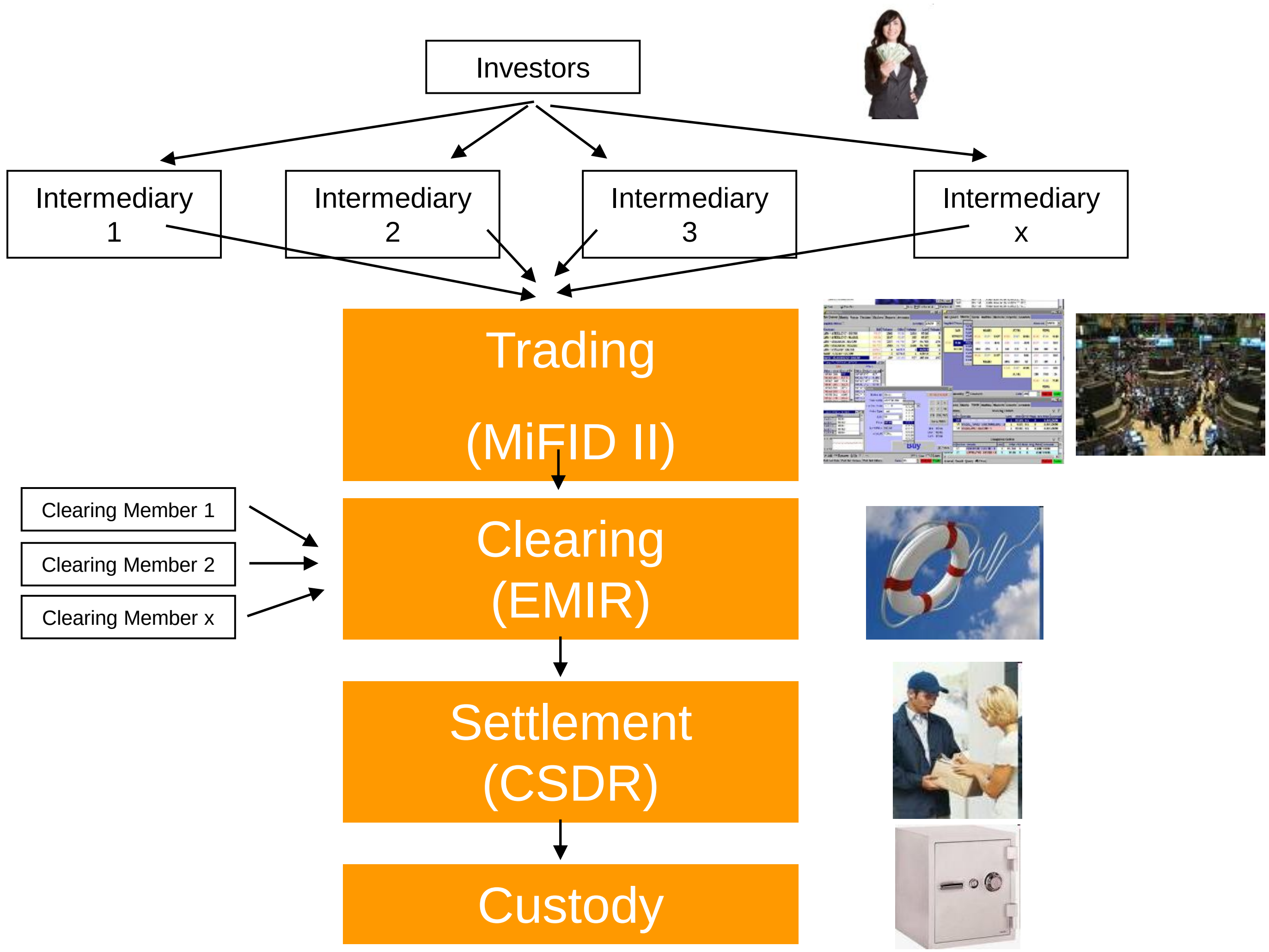
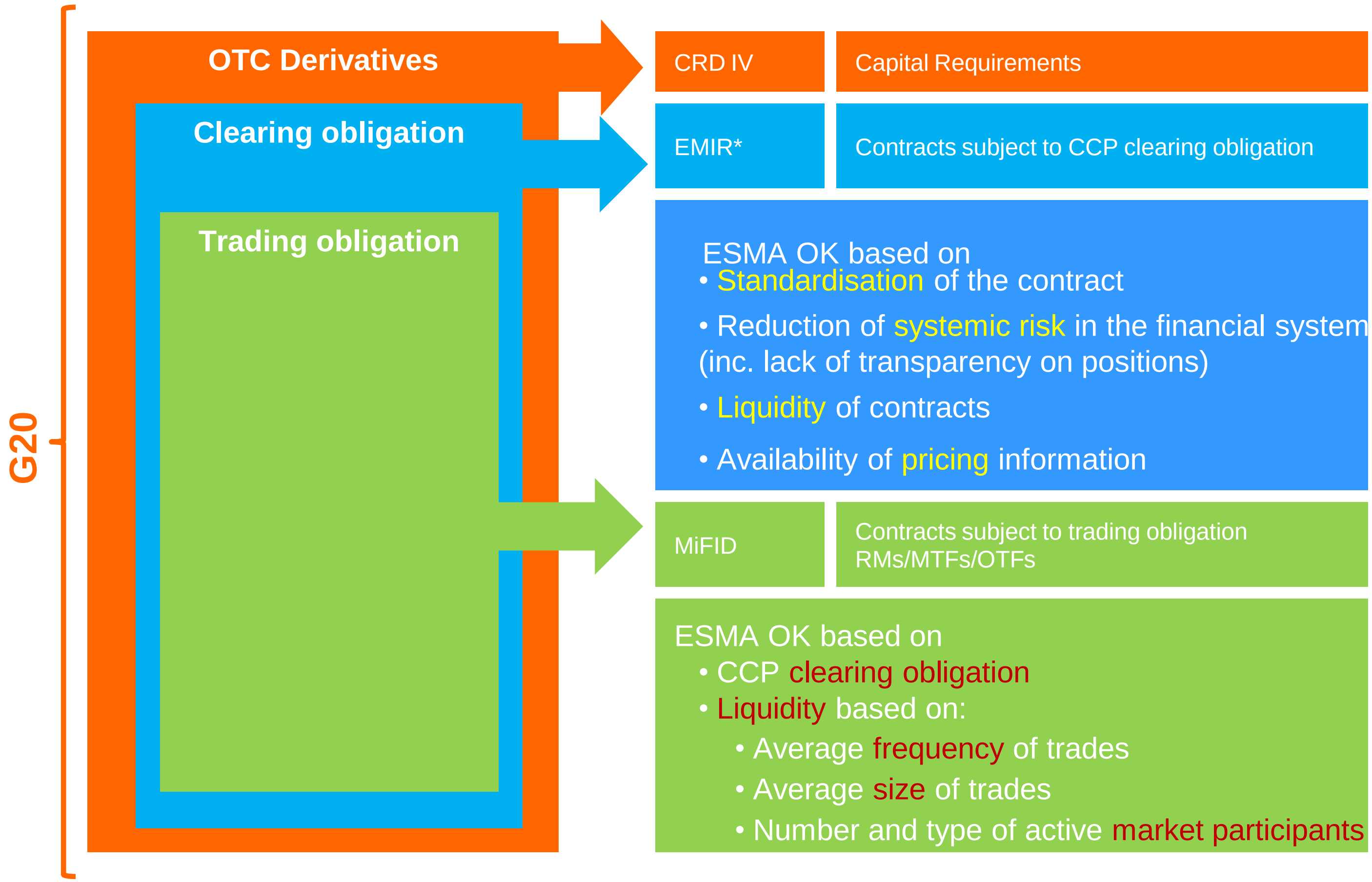
The key regulation of the trading and post-trading value chain

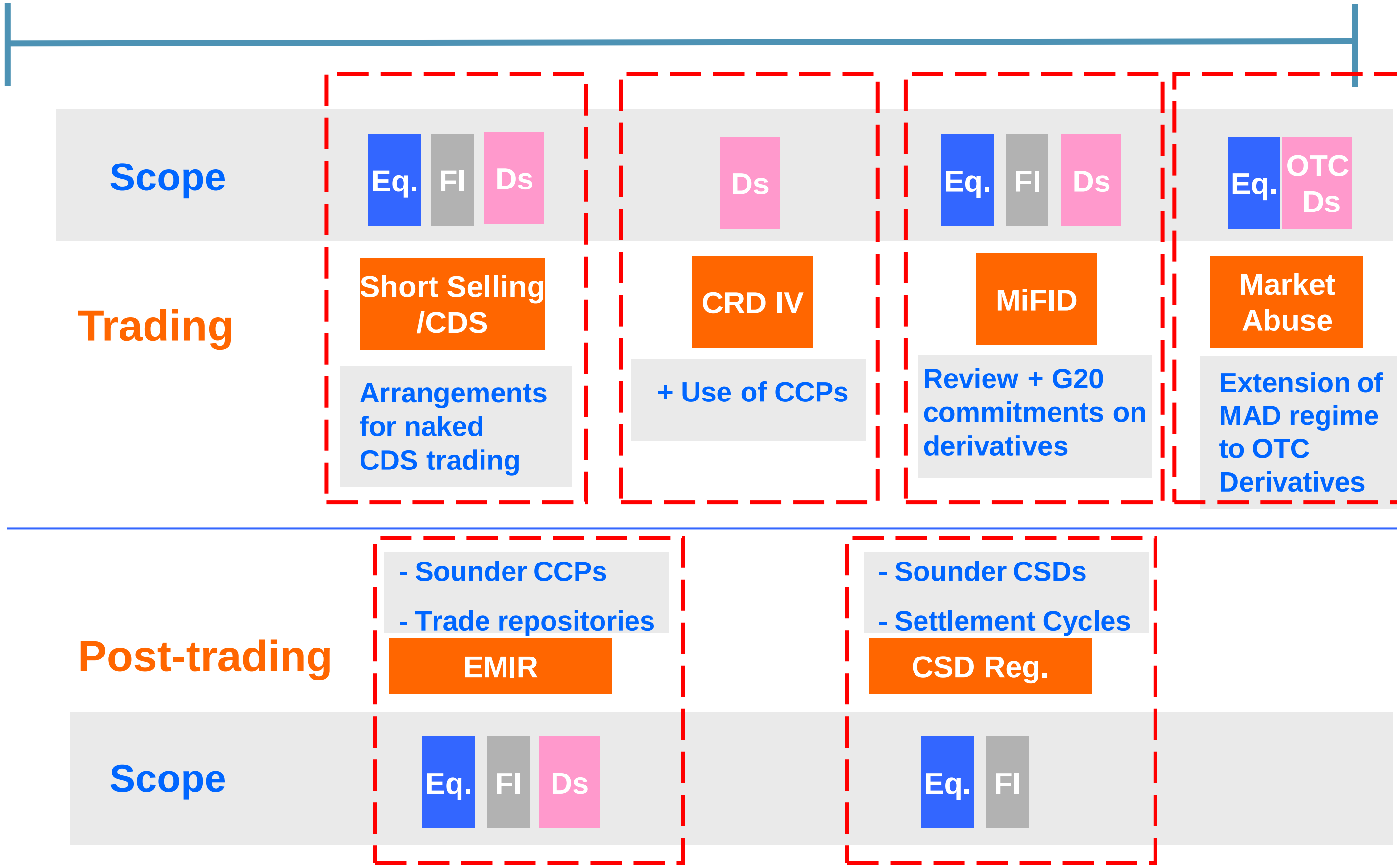


The implementation of the G20 trading mandate in the EU



* EMIR also includes a requirement for derivatives to be reported to Trade Repositories

The full regulatory landscape



Eq. = Equity; FI = Fixed Income; Ds = Derivatives

Impact of the implementation of MiFID I

- Positive impact of MiFID
  - ➢ Increase of Competition
  - ➢ Reduction of costs
  - ➢ Increase efficiency of secondary markets for Blue Chips Stocks
- Negative impact of MiFID
  - ➢ Increase of fragmentation and complexity of markets
  - ➢ More darkness
  - ➢ Development of a two-tiered market between liquid shares and Midcaps and SMEs
  - ➢ Unfair competition from broker-run trading venues
- Overall impact
  - – Commercial opportunities for the few, but limited benefits for investors & issuers!
  - – Main losers: SME stocks

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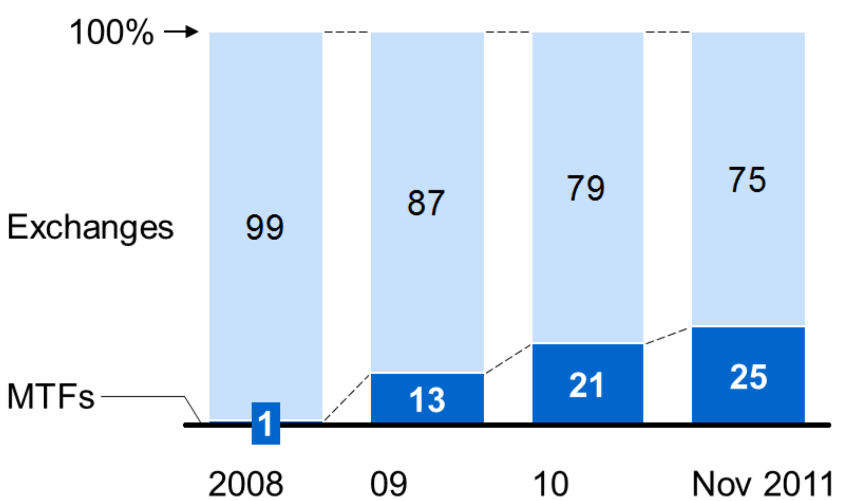
Positive impact of MiFID - Increase of Competition

Incumbents have lost market share ...

Market shares of cash equity trading in Europe

Trading value, percent[1]



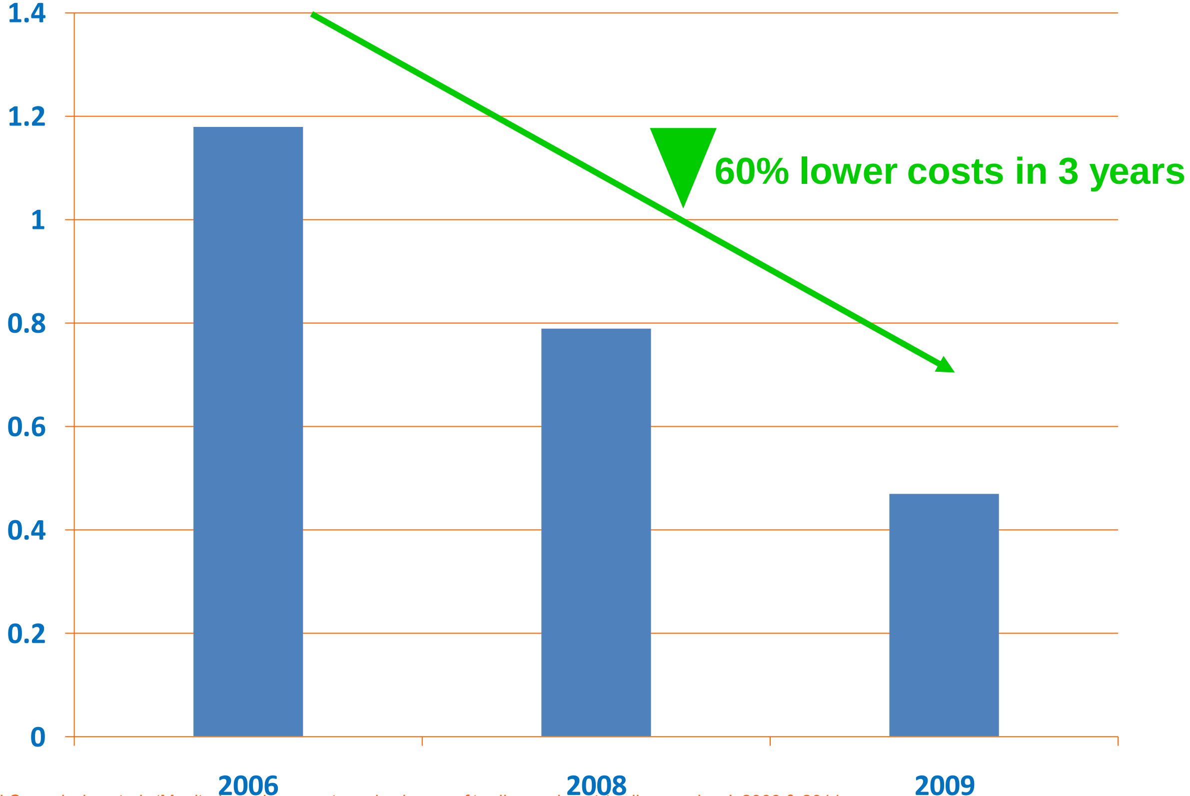
... and remain under pressure

- In Europe, introduction of MiFID in 2007 and increase in high-frequency trading supported growth of MTFs
- MTFs already account for 25% of cash equities trading volume
- Pricing of European exchanges expected to converge towards lower level of European MTFs and US exchanges[2]

1 100% of market defined as top exchanges and MTFs in Europe as of January by value traded (includes pan-European electronic order book equity trading)
2 Revenue to volume ratios of ~ 0.7 bps (European exchanges), 0.1 bps (European MTFs) and 0.12 bps (US exchanges) as of November 2011

SOURCE: McKinsey, FESE European Market Report, Morgan Stanley & Oliver Wyman

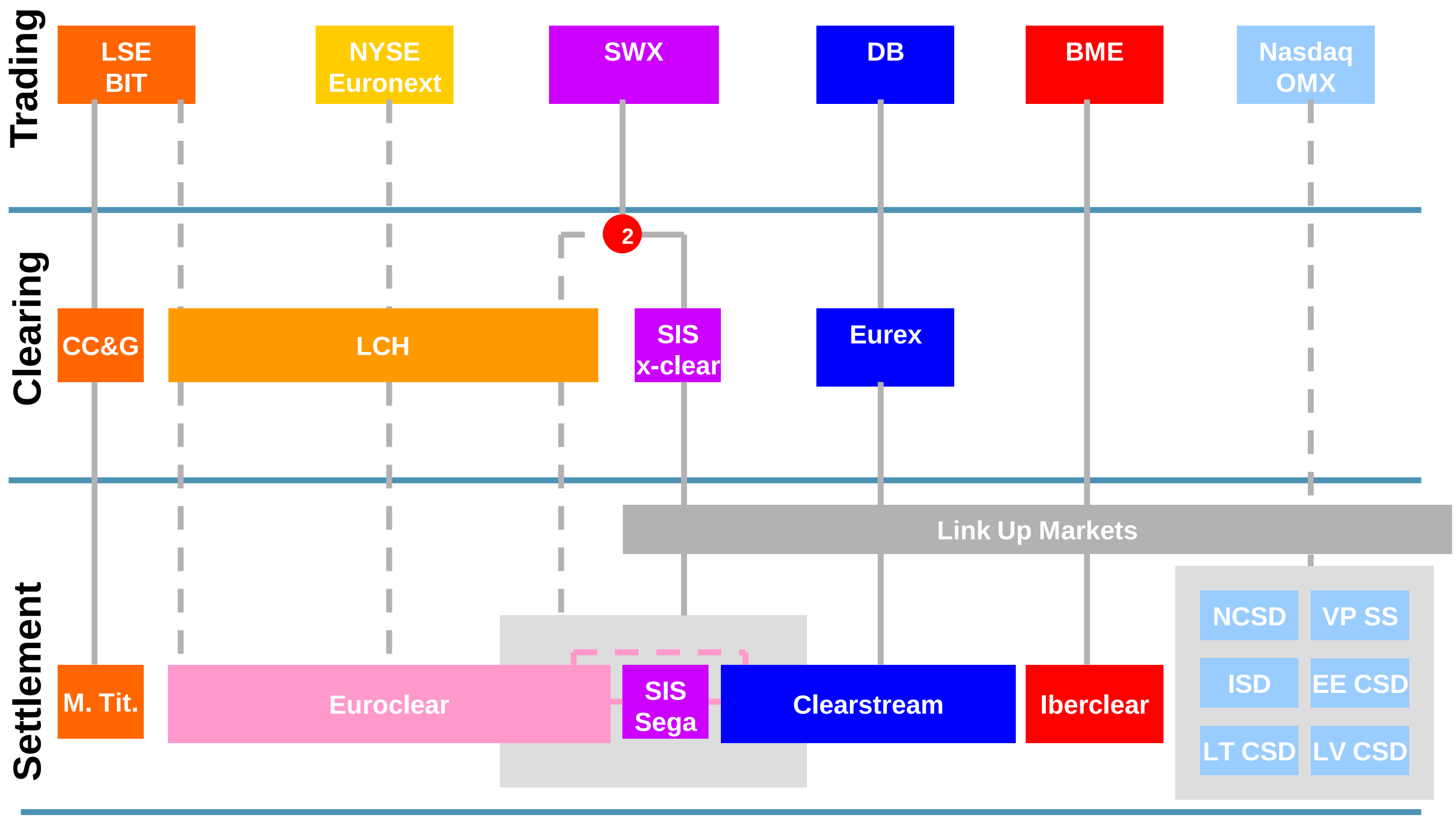
Positive impact of MiFID – Decrease in costs



Source: EU Commission study 'Monitoring prices, costs and volumes of trading and post-trading services', 2009 & 2011

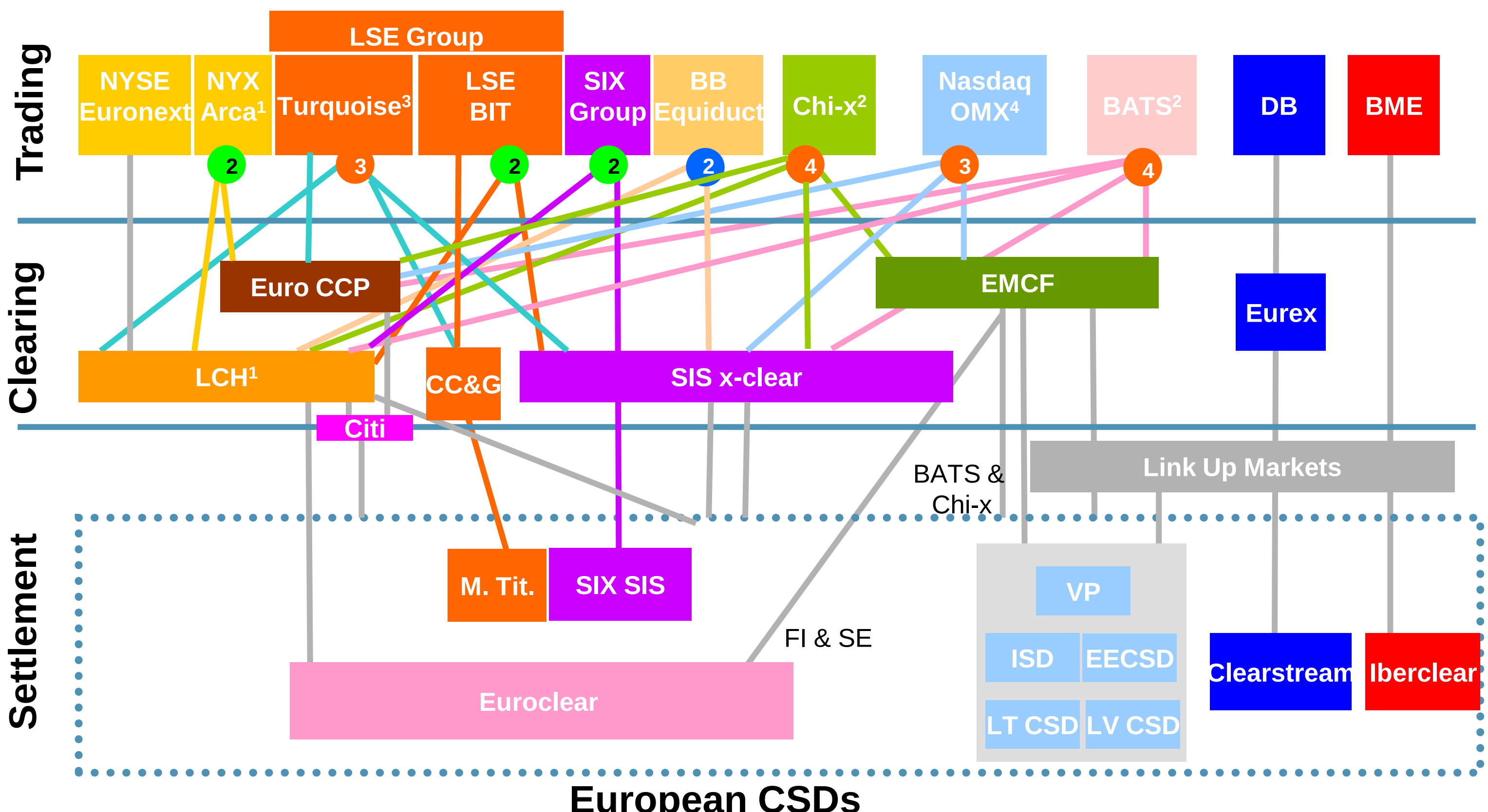
Negative impact: fragmentation and more complexity

This is the European equity landscape before MiFID I



Negative impact: fragmentation and more complexity

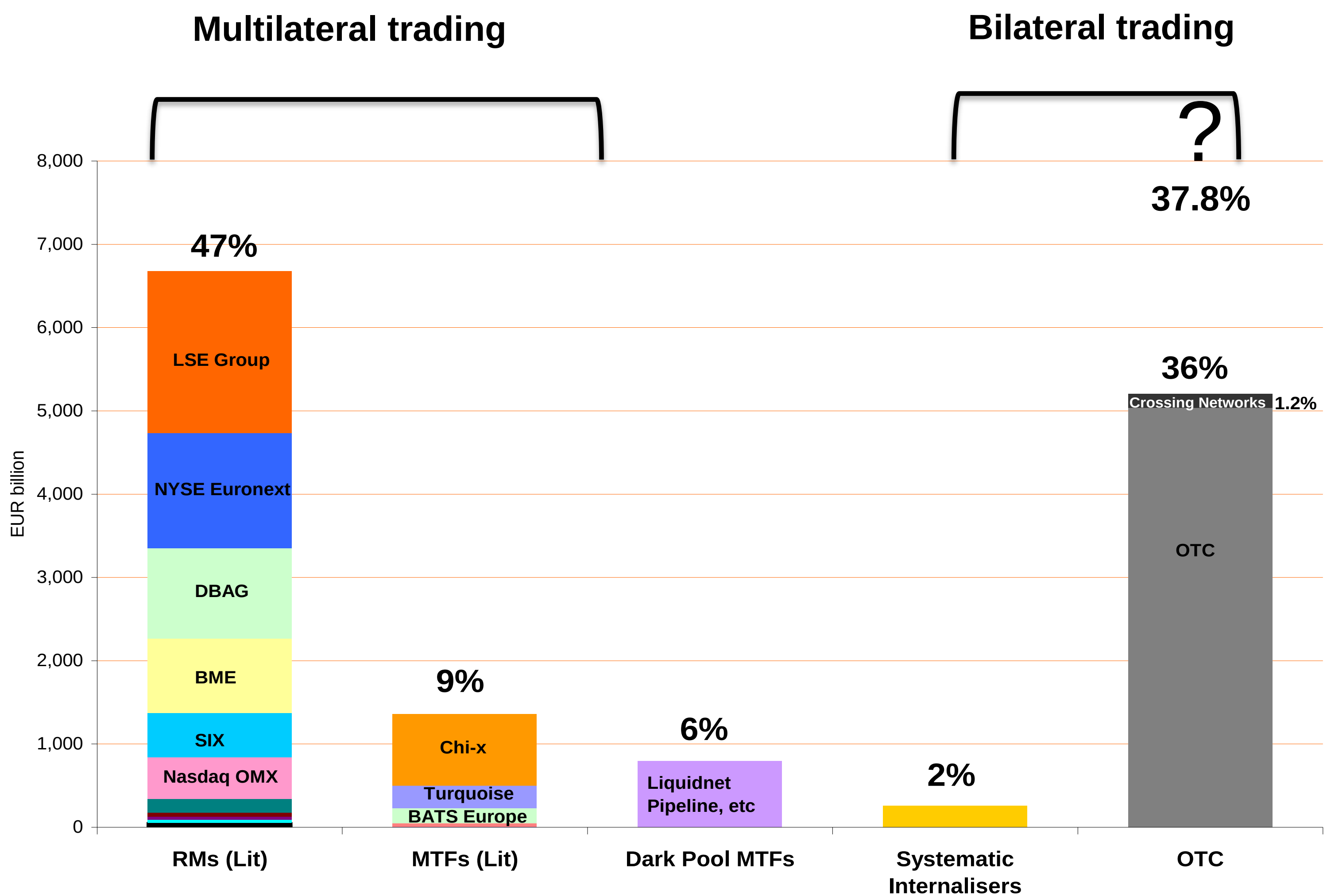
This is the European equity landscape after MiFID I



[1] In May 2009 announced competitive clearing agreements
[2] In July 2011 announced intention to offer a choice of four clearers
[3] In September 2011 announced intention to offer a choice of three clearers
[4] In October 2011 announced intention to offer a choice of three clearers

Note: In green the interoperability agreements in place, orange those on hold due to review by the regulators or to discussions between the parties, in blue other arrangements.

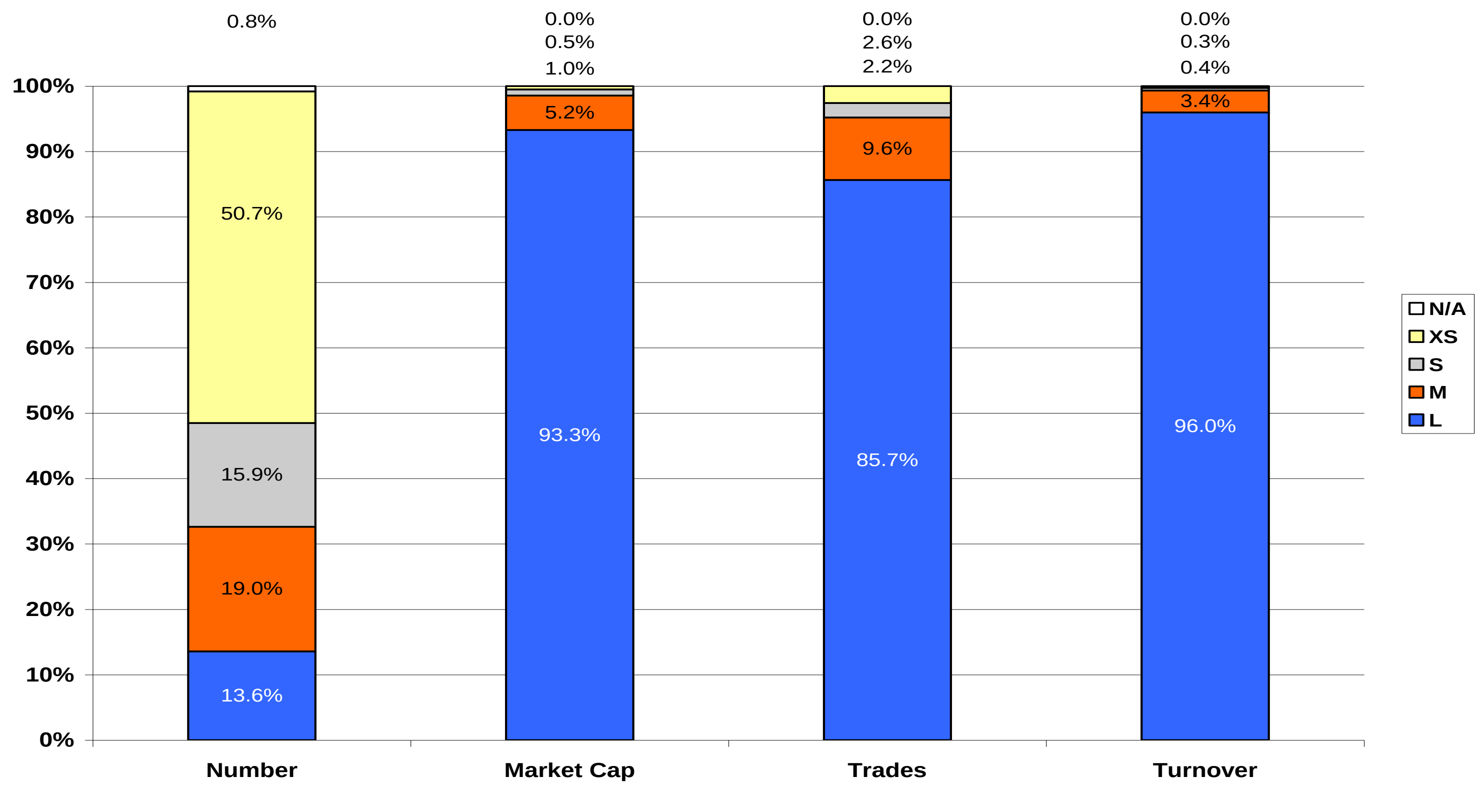
Negative impact: more darkness and unfair competition from broker-run trading venues



Note: FESE estimations reinforced with CESR CP figures on Dark trading – Dark Pool MTFs figures refer to trading under pre-trade waivers according to MiFID. Analysis based on different sources: FESE EEMR, Markit Boat, Thomson Reuters, and CESR consultation paper on Equity Markets (CESR/10-394)

Negative impact: Development of a two-tiered market between liquid shares and Midcaps and SMEs

Companies listed on EU stock Exchanges 2009



Source FESE

Note on the breakdown of instruments into size classes according to the market capitalisation end of year 2009:

- Large cap (L): market cap ≥ EUR1bn
- Mid cap (M): EUR1bn > market cap ≥ EUR150mn
- Small cap (S): EUR150mn > market cap ≥ EUR50mn
- Micro cap (XS): EUR50mn > market cap

MiFID II - Specific objectives

- Targeted improvement to help deliver more integrated efficient and competitive EU financial markets
- Tackling the loopholes and less regulated and more opaque parts of the financial system
- Increasing investor protection in specific areas to support confidence
- Updating in light of developments in markets structures and technology (HFT)
- Including activities which were not covered before (emission allowances & physically settle commodity derivatives)

MiFID II – Level II – what remains to be done

- **Volume caps for equity trading to limit dark trading**
  - There is a 4% cap per month per venue & an 8% cap across all venues to limit the negative impact of 'dark trading' on price formation.
  - The issue: how can ESMA collect and examine date from different venues across the EU in a central manner?
- **Post-trade market data provisions to create consolidated tape**
  - The issue: the Commission needs to define a system on a 'reasonable commercial basis'
- **Open access to encourage competition in on-exchange derivatives markets**
  - The aim is to allow choice of clearing
  - The issue: ESMA needs to specify when access has to be granted or can be denied.
- **HFT (which represents over 20% of trading and 60% of orders)**
  - ESMA needs to define HFT and firms need to register
  - The market making regime needs to be calibrated for investment firms that engage in algorithmic trading

MiFID II - New services- Introduction of organized trading facilities (OTF) limited to non-equity instruments

- **Introduction of organized trading facilities (OTF)**
  - for multilateral trading (in addition to Regulated Markets and Multilateral Trading Facilities)
- **The OTF definition is broad**:
  - it’s a multilateral system in which multiple third party buying and selling interest in bonds, structured finance products, emission allowances or derivatives are able to interact in a way resulting in a contract (i.e. broker crossing systems)
- **OTF limited in scope to non-equity instruments**
  - **The Issue:** ESMA needs to define the liquidity characteristics of the non-equity products that are subject to pre- and post trade transparency obligations.

MiFID II – global issues: third country access

- **MiFID I**

  - Access by non-EU firms providing investment services or performing investment advice into the EU market not harmonized but governed by national law
  - No passport available for third country firm that establishes branch in a MS – a new authorization is required in each member states

- **MiFID II**

  - Third country access gave rise to very controversial discussions
  - End result: absence of a solution per type o f client (partial harmonization only)

Impact of EMIR – Fragmentation of global derivative markets

- In translating the G20 commitment, local supervisors gave little thought to the global nature of derivative markets.
- One example is the Interest Rate Swaps (IRS) market. Since the introduction of the Swap Execution Facility (SEF) in the US, EU dealers have opted to limit their trading of euro-denominated IRS t other EU dealers.
- European firms, which are not yet subject to the trading and clearing mandate, are avoiding trading mandated products with US firms because they would need to trade on SEFs and clear through CCPs before their own domestic regulations require them to do so.
- The results:
  - duplicative and sometimes contradictory regimes creating operational, strategic and legal challenges for financial firms
  - Fragmentation along geographic lines & splitting of liquidity
  - Impact on pricing which threatens the efficiency with which end-users can access financial services & products.

Further complexifications

- **Due to the legislative inflation on**
  - Level 1 (MiFID II, MiFIR and EMIR),
  - Level 2 (delegated acts which are drafted and adopted by the Commission following ESMA advice)
  - level 2 Regulatory Standards (which are drafted by ESMA but adopted by the Commission)

- **Due to the dissemination of the texts**
  - MiFIDII and MiFIR,
  - CRD IV and
  - EMIR

- **Due to the fragmentation of the prudential supervisions framework of the investment services and activities**
  - within the Euro area SSM, national supervisors, EBA/ESMA
  - outside the Euro area: national supervisors and EBA/ESMA

What to expect next?

- Regarding MiFID I & MiFIR
  - ESMA is now in the process of reviewing over 400 responses to its consultation paper
  - Following this review, ESMA will deliver its final technical advice to the Commission and hold another consultation round fro the technical standards.
  - The issue: much of the work needs to be based on concrete data.
- Regarding EMIR
  - Derivatives markets are global and interrelated. G20 recommendations are implemented at different speeds which can create an unlevel playing field.
  - In St Petersburg, the G20 agreed that regulators should defer to each other when justified. The aim is to implement without fractioning international capital markets.
- The next Commission will focus on creating a capital market union…

What is a capital markets union?

- Jean-Claude Juncker, the European Commission’s president, has announced that he wants to create a ‘capital markets union’.
- The goals is to finance jobs and growth throughout the European Union and to have a financial system that is better able to absorb shocks. Banks are shrinking and cannot do the job of funding growth on their own.
- The solution is to strengthen nonbank finance — including shares and bonds, shadow banking and much else too.
- Politically it’s interesting: the UK is not part of the banking union but will it should be in the capital markets union.
- Further integration of the European Union’s capital markets will lead to greater critical mass and lower financing costs, as well as soften the blow of an economic shock by sharing the pain across a wider area.
- Expect new proposals from Europe soon…