POSITION PAPER

27 June 2012

Markets in Financial Instruments Directive (MiFID)

COMMISSION REVIEW PROPOSALS (MIFID II / MIFIR)

Introduction

BUSINESSEUROPE has long been a supporter of MiFID and its original objectives. The legislation has been a success in terms of enhancing investor protection, reducing trade barriers in the European securities markets, and increasing competition between trading venues and financial institutions, helping to reduce the costs of trading. It has led to further integration of the single market and forms a key part of the EU's financial market legislative framework.

Nevertheless, there is a feeling amongst non-financial companies that MiFID has bought about some less desirable outcomes such as fragmentation of equity markets and the emergence of high frequency trading, with impacts on equality in terms of market access.

In order to ensure that European commercial enterprises have proper access to financing, the legislative package should address both the weaknesses of the existing regulation regarding equity markets and dysfunctions revealed by the crisis on other financial markets, while not seeking to undermine the progress already achieved by the existing Directive.

Regarding the latter, the legislative proposal as part of the MiFID review essentially attempts to resolve problems that appeared on equity markets by imposing an equities-type trading structure onto the non-equities world.

However, at all stages of the reform it must be considered that the markets are not "plumbing neutral". Non-equity markets (e.g. bonds) are by nature illiquid since the objective of investors is to benefit from their financial characteristics matched with a maturity ("*buy and hold market*"). This is a main difference with shares which don't have any maturity. This is the reason why pre-trade transparency provisions should be adapted to these market specificities, while waivers should be defined in a way which does not exclude too large a part of transactions at the risk of being harmful to the price discovery process.

The proposals should also avoid to fundamentally alter the way in which European corporates interact with the financial services industry in terms of how they are able to manage (hedge) their risk. It is important that non-financial companies are not discouraged from using customised contracts to hedge business-specific risks (see section on 'Maintaining the Over-The-Counter Market' below).

Reforms should make it easier for companies to access market funding and we caution against strict equivalence requirements. Our membership is representative of non-financials who operate global businesses based in Europe who need access to non-EU capital, investment, and information in order to grow their businesses and create jobs.

AV. DE CORTENBERGH 168
BE-1000 BRUSSELS
BELGIUM
VAT BE 863 418 279

BUSINESSEUROPE a.i.s.b.l.

WWW.BUSINESSEUROPE.EU

TEL +32(0)2 237 65 11
FAX +32(0)2 231 14 45
E-MAIL: MAIN@BUSINESSEUROPE.EU
EU Transparency register 3978240953-79

New rules should strike a balance between maintaining investor protection and ensuring that corporates can access non-EU markets.

Transparency and Exemptions

Our members understand and acknowledge the European Commission's intention to enhance market efficiency / price formation and appreciate the role that market transparency can play in furthering these goals. However, companies remain concerned by the lack of transparency in two areas: the size of the business evading pre-trade transparency and the quality of post-trade transparency. Regarding the former, there is potentially a wide effect of the proposed waiver mechanism, which might defeat the objective of tightening its scope of application. We would therefore support the compromise by the Danish Presidency to restrict the basis for granting waivers; for equity, waivers should only be granted for orders that are large or held in an order management facility.

Having said this, we consider that derivatives used by non-financial companies that are not subjected to the clearing obligations under EMIR should be exempted from the transparency obligation on account of their not representing a systemic risk and/or their being used for hedging purposes, as acknowledged by EMIR. We also consider that in developing standards to determine the sufficiently liquid derivatives which will be declared subject to the clearing obligation, ESMA should take into account the specifics of the derivatives, especially whether they are bespoke or used for hedging purposes.
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Imposing an obligation to publish quotes (pre-trade transparency) and details of executed trades (post-trade transparency) could have the unintended effect of identifying the non-financial counterparty. Publication of any order from the non-financial company executed by appointment could identify the company, particularly in thinly-traded securities and illiquid markets. This risks revealing the company's hedging and commercial strategy to its competitors.

Even in cases when a company's identity is not exposed, inappropriate pre-trade transparency requirements can impact on prices negatively, particularly for non-equity securities where the trade is relatively large in size or the security is particularly illiquid. This is because there is a proven trade-off between liquidity and transparency. It is therefore essential that any mandatory pre-trade transparency rules applied to non-equities are properly calibrated, and take into account the nature of the market and instrument they are imposed upon. Furthermore, additional costs linked to publication raise expenses overall which in turn harm the efficiency of corporate risk management.

Furthermore, transactions related to significant distributions in which prices are typically formed through book-building processes should (similar to the situation in the US) be excluded from the post-trade transparency requirements, not just for primary issuances but also in the case of secondary offerings. Post-trade transparency serves here only to make the unwinding of cross-holdings between corporates more costly.

Transparency obligations for customised derivative contracts are not justified from an investor protection point of view. In addition, EMIR will require the reporting of derivative transactions to trade repositories for supervisory purposes.

We support the amendments to the ancillary activity exemption clause but we believe that the exemption regime should be further developed and improved to provide greater clarity and certainty to market participants and ensure consistency of application across Member States. The ancillary activity exemption must not be interpreted too narrowly. It should be translated into clear legal language that non-financial companies using derivatives mainly for hedging purposes are exempt from the new rules. Furthermore, it should be ensured that small and mid-sized energy traders which trade commodity derivatives on their own account as a main business and are therefore not covered by the existing exemption are explicitly excluded from application of the new rules. Amendments that narrow the ancillary activity exemption even further will render the exemption of little use, even for non-financial firms which manage their commercial risks.

Commodity derivatives with physical delivery are supposed to be regarded as financial instruments according to MiFID/MiFIR in case that they are settled on an "Organised Trading Facility" (OTF). Non-financial companies use electronic platforms to increase the efficiency of bilateral transactions. Such platforms could therefore be regarded as OTFs or MTFs in the future. Likewise, commodity derivatives which are used by commodity firms for commercial reasons (e.g. concerning gas or power contracts with physical delivery) could be drawn into the scope of application of MiFID/MiFIR. Consequently, the purpose of the exemption provided for in Article 2 paragraph 1 lit. i MiFID, to exempt non-financial companies from the scope of MiFID/MiFIR if their own transactions with financial instruments is considered to be an ancillary business, would be seriously affected. The business with, for example, gas and power remains a main business activity of commodity firms. For this reason, we suggest to exclude commodity derivatives with physical settlement which are used exclusively for commercial purposes from the scope of application of MiFID/MiFIR.

Furthermore, we note that the OTF operator would be prohibited from trading against its own proprietary capital. Allowing clients to interact with the proprietary capital of the platform operator improves liquidity and, thus, makes it easier and more cost effective for clients to buy and sell financial instruments, including to hedge their risks. Therefore, when it assists best execution for clients, whilst also providing liquidity to the market, trading against proprietary capital should not be prohibited. Potential conflicts of interest between the OTF operator and clients in transactions over bonds and derivatives should not be addressed through a ban but, rather, by means of appropriate management and disclosure under MiFID's conflict of interest rules.

Maintaining the Over-The-Counter (OTC) Market

It is essential that corporate end users have full access to properly functioning OTC markets. These markets perform a fundamental role in the risk management of corporate end users as they allow them to define trades according to their exact requirements, thereby allowing them to tailor hedges to the specific risks they face in the course of their business. It is possible that a significant proportion of these trades / hedges will be conducted over an exchange (or OTF). However, if a corporate is trying to hedge a specific risk, it may be the case they will only be able to completely hedge their risk by tailoring a trade specifically for this purpose. In such a case the corporate may wish to execute bilaterally with a bank that has the capability to structure a hedge specifically to satisfy its needs. The MiFID review should not attempt to alter or prevent this.

Systematic Internaliser Regime

There are also significant concerns with regard to the application of the systematic internaliser (SI) regime to non-equities.

Under the proposal, firms interacting with their clients on a bilateral basis would have to do so in the capacity of Systematic Internaliser (unless the trade is defined as 'pure OTC' – the definition of which is currently unclear). As drafted, when a firm acting in the capacity of an SI receives a request for a quote from a client (and the firm decides to provide a quote), the firm must also make that same quote firm to all other clients – whereby the other clients can execute against that price. This creates a number of different issues.

- Due to the nature of the SI regime (i.e. the fact that prices must be sent out to all clients of the SI), it is only suitable for the most liquid products. Indeed, under MiFID 1 the SI regime was applied exclusively to equities. Even then, only the most liquid equities (the so called 'liquid shares') were in scope of its requirements. However, MiFID 2 is attempting to apply the SI regime to non-equities (derivatives, fixed income, structure products etc.) without demonstrating that those requirements are neither needed, nor adapting them to suit non-equities. The general lack of liquidity in non-equities markets (relative to equities) means that they are largely not suitable for being traded via an SI. Furthermore, the current proposal contains no restriction to the most liquid non-equities – as is present in the equities SI regime.

- The SI regime for equities does not have to take into account counterparty credit risk on the basis that it is a cash (spot) market. However, derivatives markets require two counterparties entering into a contract with each other - the value of which will be based on future events. If a firm acting in the capacity of SI enters into a derivative contract with a client, it must be able to take into consideration the counterparty credit risk of its counterparty when pricing the trade (i.e. the likelihood the client will be able to settle the contract). If a firm – acting in the capacity of an SI – has to offer the same price to all of its clients, it will not be able to take into account differing levels of counterparty credit risk across its clients. This will leave the SI unable to manage its risk effectively and force it to implement defensive pricing strategies, i.e. it will base its price on the lowest common denominator (or the riskiest client). This will result in European businesses receiving an overall worse price than previously.

- As drafted, the SI regime for non-equities poses significant operational challenges to the corporate community. The design of the SI regime implies that a streaming-type mechanism would be necessary for an SI to communicate to all its clients that it is offering a firm price in a specific instrument below a certain size. However, the decision as to whether prices are streamed to clients is currently – and should remain – driven by the client itself. Many corporate end-clients do not want prices streamed; firstly because of the significant physical expense involved in establishing the stream; and secondly because they prefer simple methods of trading and interacting with banks (for instance, over the phone).

From our point of view, the way this regime functions has to be precisely defined for each market segment in order to make it feasible from an operational and practical perspective.

Additionally, as stated above, we are worried by the proposed pre-trade requirements for SIs and the application of these rules to non-equity markets as they could have the unintended effect of identifying the non-financial counterparty. There is a serious risk that these proposals will harm the liquidity in the bond markets and lead to investment firms and banks not being able to quote prices on bonds at the large scale they do currently to their clients. Such far-reaching pre-trade transparency in bond trading is neither called for by investors nor by investment firms.

Supervisory Powers and Position Limits

The proposed regulation also grants to supervisory authorities the powers to:

- prohibit or restrict the use of certain financial instruments
- request information regarding derivative exposure
- require reductions in exposure or limits in positions.

From our point of view those powers must not discourage non-financial companies from using derivatives to hedge risks and be sufficiently well defined to avoid legal uncertainty. We therefore recommend exempting risk mitigating derivative contracts of non financial companies from the supervisory measures. Supervisory authorities must also ensure an effective level playing field between EU States and prevent distortions in the way regulation is applied by national authorities.

The draft directive contains an obligation for market operators to set limits for contracts that market participants are allowed to conclude in a certain period of time (Article 59). These limits would interfere with the risk-management concerning derivatives of non-financial companies. Furthermore, it would curtail the flexibility of market operators to set position limits on a case-by-case approach in order to maintain trading efficiency.

Although the distinction between position limits for risk-mitigating purposes and other purposes as proposed in the draft report moves in the right direction, it also intends to delete the possibility of position management as more flexible alternative to "hard" position limits. This would result in a serious drawback for non-financial companies. We suggest to completely delete the establishment of position limits or – at least – to exempt risk-mitigating instruments of non-financials from this obligation.

Furthermore, (real time) reporting of market participants to market operators concerning positions of commodity derivatives and emission certificates or derivatives hereof is problematic (Article 60). This obligation is derived from supervisory requirements according to which market operators have to publish these positions on different aggregation levels and to report them to supervisory authorities. The necessity for the requirement is not obvious; the respective rule is superfluous and would only result in costs regarding the establishment of a respective infrastructure. Firstly, the proposed reporting requirement refers to positions which are exclusively traded on the respective trading platforms. Therefore, the data is already available by the respective market operators; a further notification is not necessary. Secondly, a reporting especially for derivatives is redundant as EMIR already provides for such an obligation.

Thus, we would favour deleting the additional reporting requirement laid down in Article 60.

Data consolidation

As regards data consolidation, we believe that this should be attributed to a public authority, such as the Competent Authority, instead of leaving this to private subjects. In our view, this would improve effective and efficient data consolidation.

Emission Allowances

Regarding emission allowances, industrial, aviation and energy companies are required to enter the spot carbon market to cover their greenhouse gases emissions. BUSINESSEUROPE strongly favours appropriate tailor-made measures for enhancing oversight, transparency and integrity of the spot-trade in carbon instruments rather than classifying the instruments as financial instruments and include them in the scope of MiFID. Such an approach would strike the proper balance between adequate market oversight on the one hand and acceptable compliance requirements on the other.

Including emission allowances in the scope of MiFID could reduce the cost-effectiveness of the ETS and impose an unnecessary bureaucratic burden on companies. Should the qualification be maintained, there is a need to further clarify the scope of the proposed exemptions under MiFID. The specific nature of ETS allowances should be underlined and it should be ensured that this qualification will not affect the implementation of ETS rules and, more broadly, of the EU environment and climate policy. For that purpose, it should be specified that it only applies within the framework of the Directive and should not have any consequence on legal and/or accounting requirements.

SME Growth Markets

Regarding SME growth markets, we agree that access to capital markets for SMEs should be enhanced. As a consequence of the impact of Basel III on SMEs financing, we believe that this is a crucial issue which should be dealt with under a global approach. We are, however, not convinced that the proposed measures are the best response to the problems:

- Registration as an SME growth market could entail considerable administrative burdens for existing trading platforms and the requirement that the majority of issuers should be SMEs up to a market capitalisation of €100 million would likely lead to only new trading platforms registering. This would increase fragmentation in the market. It would thus be better if any company – regardless of the size of its market capitalisation – should be able to register.

- Furthermore, we object to expanding the scope of the Market Abuse Regulation to existing platforms. Expanding to SME markets the obligations applied to regulated markets is not the best way to improve SMEs access to financial markets.

We suggest that the Commission launches as soon as possible a public consultation on that subject in order to identify the main issues and elaborate an appropriate proposal.

Corporate governance

Proposals concerning governance in investment firms should be coherent with national company law rules. This is not the case, for instance, when the proposal only refers to a one-tier management system given that a two-tier management system is required under some Member States' legislation. MiFID is not the right directive to set corporate governance rules for investment firms which also have banking licences. The regime is aimed at regulating financial markets and requirements concerning corporate governance are already addressed in the capital requirements rules and in the European Supervisory Guidelines. Duplication should be avoided through the creation of an exemption for the governance rules of investment firms which also have banking licences and which have to adhere to corporate governance rules imposed upon banks as a result of the capital requirements rules.

Third Country Regime

Last but not least, new rules regarding access to the EU for financial services providers based in third countries should be based on clear rules. Such rules should ensure for non-financial companies direct and/or indirect access to non-EU firms including in emerging markets. Our membership is representative of non-financials who operate global businesses based in Europe who need access to non-EU capital, investment, and information in order to grow their businesses and create jobs. New rules should strike a balance between maintaining investor protection and ensuring that corporates can access non-EU markets, including those which are less developed and would not pass an equivalence assessment. Such new rules should be implemented under ESMA and allow for an exemptive regime between EU firms and professional market participants, such as brokers. In this respect, the rules should specify and clarify how this mutual recognition will be assessed with a reciprocity concern approach.

That being said, we caution against strict equivalence requirements and would like to underline the importance that jurisdictions with comparable regimes recognise each other's rules in the interest of good functioning financial markets and ensuring a global level playing field. Furthermore, we are in favour of the introduction of a reciprocity test which entails an assessment of whether a third country grants access to EU investment firms on their markets under similar conditions. Such an assessment can help to prevent the application of double or conflicting rules.

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