Date: 3 November 2010
Ref.: CESR/09-1218

PUBLIC STATEMENT

Of:	**Market Participants Consultative Panel (MPCP)**
Date:	10 December 2009
Location:	CESR premises, Paris

Summary

The MPCP met on the 10th December 2009 in Paris to discuss six issues with the following result:

- MPCP members continue to be concerned about the current situation in financial markets and the economy more generally. Going forward, risks stem from the perspective of low growth over a possibly extended period of time, inflation from 2011 on, commercial real estate at a horizon of three years, and exit strategies from current public policies. Concerning CCPs the right balance needs to be found between centralized and bilateral solutions.
- The evolution of the structure of trading: members highlighted the difficulty to define "dark trading" and, for Europe, the lack of pre-trade transparency concerning order books (OTC or not) was highlighted. Dark pools seem more prominent in the U.S in comparison to Europe, although this gap may evolve quickly. Differences between MTFs and crossing-networks were stressed. Crossing-networks, which are not covered by the legal notion of MTFs, are currently smaller, but again this may evolve. There was a sense that OTC trading will become more transparent over time in terms of clearing and reporting. Concerning High Frequency Trading (HFT), it was stressed that the main players in Europe are investment banks and hedge funds, and that retail investors and institutional trading do not use HFT with the same objective. Algorithmic trading already has and is expected to continue contributing to decrease costs in a significant way. A system break is possible as algorithmic trading relies on a reference price, but breaking series of trades after they are done is not a very attractive option.
- Concerning compensation practices, members highlighted the need for reform because of past excesses. It was, however, also stressed that the issue of incentives is a difficult one in this area. Care needs to be taken to focus on those areas where incentives have a link to risk policy, and to avoid extending any rules to wider areas only after due investigation of the effects. It was considered advisable that the issue be addressed at the level of corporate governance through the right incentives given to shareholders and managers.
- MPCP members welcome the proposals on PRIPS, but also stressed some issues, like key elements of investment advice currently absent (information given to the client about whether the selling agent advising or not, tied agent or not, legal uncertainty about advisory status). The ambit concerning inducements should create a level playing field across the whole spectrum of financial services, including insurance companies and pension funds.
- A range of proposals were made concerning the agenda of the new Commission. The proposals concerned: knowledge economy, smaller listed companies, (long- and short-term shareholders, hidden ownership and empty voting, short selling, intermediary costs on CAs and GMs, future securities law directive/ shareholder transparency.
- Some proposals have been made for topics for the CESR work programme.

The Chairman of the MPCP, Carlos Tavares, welcomed the new members: Mr. Ovidiu Sergio Popp, Mr. Eric Thedéen and Mr. Jaap Winter.

Agenda item 1 | Update on market developments

In the US, the financial regulatory reform bill (including the creation of a new so-called Consumer Financial Protection Agency, CFPA) which is in the pipeline is unlikely to pass before the end of the year. Concerning securities authorities, it is interesting to notice that the SEC, which attracted much attention since the crisis, is likely to be submitted to less changes than the CFTC. Some consolidation among banking authorities is likely.

In the light of abundant liquidity, fears of new bubbles have been voiced. The identification of bubbles ex ante is very difficult if not impossible, but there may be necessary conditions for the formation of bubbles which may permit excluding that a bubble is developing in a given situation. At least for the U.S, some economists (e.g. Phelps and Mishkin) have recently argued along these lines that in the current absence of credit growth, there is no reason to fear a bubble.

There is, however, a concern about government debt and, as a result, high long term interest rates. One key issue is the affordability of the debt, which could well pose serious problems for some countries, particularly considering the rating thresholds policy applied (the ECB currently accepts collateral as low as BBB-, but is likely to normalise its policy to the usual minimum rating of A- in 2011).

The quick recovery of the banking sector is largely due to central bank policy (dividend policy is indeed likely to depend largely on public support measures), the resurgence in some areas of business, and the more or less intensive competitive pressure which seems to be an issue particularly in some areas of investment banking and could lead to mergers among savings banks in at least some European jurisdictions. Regulation is likely to lead to a significant increase in capital requirements. This perspective might be one reason why credit supply currently is subdued, besides expected write-downs due, for instance, to an increase in credit defaults. Going forward, it seems reasonable to expect that banking services will become more expensive, and, perhaps, their market share will, in comparison to securities markets, decline. In the Nordic countries, the situation seems rather favorable in comparison to the rest of Europe. In the CEECs, capital markets are still underdeveloped and the countries concerned make considerable efforts to change the situation.

Several MPCP members concurred on the risk of a W-shape recovery whereby the second dip would unlikely to be as strong as the first. Currently, the valuation in markets is broadly along historic lines, with, perhaps, a slight overvaluation. Growth could well take five to ten years to significantly recover which is likely to create strains for employment. Inflation is unlikely to be a serious topic in 2010, but could become center stage from 2011 on – developments in this area very much depend on the crucial issues of exit strategies chosen and the way they are implemented by central banks. Because of refinancing needs, the commercial real estate sector could well be at the origin of significant pressure at a horizon of three years. Currently the situation still corresponds to a managed crisis. There is a general incentive problem, as intervention by the public sector takes away pressure to change behavior (contingent convertibles were seen as providing some positive effects through their potential pricing of risk, but this market was also considered as being difficult to fully develop, price, and explain (assure proper disclosures depending on to whom sold), and the potential of such instruments to pose risk of a self-fulfilling crash as one gets close to the trigger value of this financial instrument; these instruments are given in exchange for debt within an insolvency or pre-insolvency situation when there would be an incentive to take them).

Several specific issues were mentioned (including in relation to risks created by regulation: a) the collateral requirements (at the clearing stage, but also more generally) very much depend on ratings; according to general market practice, in case of several ratings, the lowest is chosen on prudence grounds. This practice is likely to lead to a significant increase in collateral requirements going forward; b) the repo market would be submitted to significant strain by defaults of banks.

Concerning the creation of CCPs, it is key to find the right balance between centralised and bilateral clearing as CCPs concentrate risk, and do not eliminate it. Regulators should be careful not to be intrusive when it comes to clearing. Setting the right incentives is a key requirement.

Agenda item 2| The evolution of the structure of trading – dark pools and high frequency trading

Dark pools

The difficulty to define "dark trading" was highlighted. One definition sometimes used refers to order books – OTC or not – that lack pre-trade transparency. The lack of pre-trade transparency in comparison to exchanges might lead to reduced price discovery in markets, and the absence of a central counterparty (CCP) has the potential to pose stability risks.

Dark pools seem to be more prominent in the U.S. than in Europe, whereas it is the opposite for the share of OTC trade (~30% in Europe against ~13% in the U.S.). Not much seems to be known about the profitability of dark pools which is a key element in the possibly prolonged phase of market entry and acquisition of market share until a dark pool becomes viable.

The attempt to reduce the extent of OTC trade by MiFID was unsuccessful. One reason for OTC trades is to carry out block trades outside the market to net more markets.

In the U.S., crossing networks allow for deals with small size. There is a difference between MTFs and crossing-networks in regulatory terms: less pre-trade transparency, stricter regulation (particularly in terms of surveillance to prevent market manipulation), and equal access. Crossing networks, which are not covered by the legal definition of MTFs (even though one might argue that the two are similar in economic terms), are currently very small. Most exchanges run MTFs as well.

Is there a risk of having retail orders concentrated in regulated markets and wholesale orders in OTC - similarly to what happens in the bond market? In such case, price formation on the exchange could become insignificant.

Currently the market capitalisation is increasing, but trading volume is stagnating or decreasing both on regulated markets and MTFs in favour of OTC trades which is often not known in an exact way.

There is a sense that OTC market will become more transparent in terms of clearing and reporting over the next five years or so (whereas it could well be the opposite for equity markets). This would be welcome by issuers who currently do not know where their shares are traded.

It was highlighted that it is important that the trading on exchanges are treated fairly from a regulatory point of view when compared to the new venues.

High Frequency Trading (HFT)

As it adds volume, HFT seems to have a positive, rather than a negative, impact on market liquidity. In the U.S., where hedge funds and algorithmic trading firms are the main drivers of the business, 50% of the trading is due to HFT. In contrast, in Europe, the main players are rather investment banks.

There are different types of HFT: retail market makers (whereby orders are bought from retail brokers), institutional trading, and proprietary trading. The latter two varieties often use it as a way to exit positions.

Algorithmic trading depends on speed and focuses on low costs, which indeed fell by about 70%. The trade order rate for a typical order - a number of trades are indeed withdrawn - is considerably higher in Europe (23%) than in the U.S. (8%). A system break is possible in the area of algorithmic trading as it relies on the existence of a reference price, and breaking series of trades after they are done is not a very attractive option.

There is a significant impact on liquidity which can be both positive and negative. This led some to compare HFT/algorithmic trading to a "derivative on liquidity".

Sometimes the issue of market manipulation is raised, whereby the only issue is the possibility to push prices in a certain direction. So far, no empirical evidence has been presented in favour of his thesis - which is admittedly difficult to provide for. In this regard, it was suggested to investigate more closely the link between liquidity and HFT velocity/turnover.

Agenda item 3 | Compensation practices

It was stressed that compensation policies are not as straightforward a subject as it sometimes appears in the current public discussions. Academic studies have, for example, shown that compensation policies do not generally create bad incentives in terms of risk, and that the problem of risk often is not bad incentives coming from remuneration schemes, but rather that it is difficult to identify risk in advance. Nevertheless, there is a strong case for reform because of excesses (e.g. the recommendations of the European Corporate Governance Forum). This is particularly true for those banks which create significant negative externalities.

In this regards, a distinction would need to be made between different staff within the area of risk management depending on the degree of their decision power with respect to risk policy. Also, one needs to keep in mind that traders often have a special status with respect to compensation and they generally are tightly controlled. Nevertheless, it should be kept in mind that when compensation policies are restricted, measures are taken to avoid them: this is certainly the case in the U.S.. The reason for such high bonuses is because there were limits imposed (by taxes) on base compensation.

Rules on remuneration are not easily read across to the AIM industry because of conceptual issues (risk of price regulation). It should also be kept in mind that in this industry the link between performance and asset withdrawal sometimes is strong. There are different risk taking functions between banks and the AIM industry. Nevertheless, one standard example of systemic risk generated within the AIM industry, the LTCM case, needs to be kept in mind.

One question relates to the right level at which the problem of remuneration schemes needs to be addressed. Here the role of corporate governance mechanisms (concerning the link between shareholders and managers, including risk managers and the way the risk reporting is taking place) could usefully complement or even replace public intervention. Thereby, it is key to take account of the considerable diversity of corporate governance structures. The simple alignment theory (shareholders/managers) which focuses too much on a reduced set of variables needs to be complemented and performance pay be made dependent of a range of variables to reflect risk.

Agenda item 4 | Packaged Retail Investment Products (PRIPs)

Though the basic idea of PRIPs - having similar rules for the points of sale – is welcome, there are a range of issues linked to it.

As regards to scope, the current ambit could be wider, and the disclosure standard, with as benchmark KID, should be adapted according to product and be made compatible with MiFID.

Also, for selling rules, MiFID is the benchmark, but some key elements of investment advice are not part of MiFID (informing the client about advising or not, tied agent or not). As a result, there exist considerable conflicts of interest (e.g. there is uncertainty as the advisory status is legally unclear). Also, concerning the ambit of inducement, there is an unequal level playing field in terms of product. The issue of inducement was considered key, in particular with respect to the insurance and pension fund industry (e.g. unit-linked products, open-ended pension funds).

One other issue is the diversity of regulators in charge of the area of the proposed regulation. This creates a patchwork of oversight within which it is difficult to achieve a level playing field. What would be needed is an encompassing framework for retail investment.

Overall, the objectives of investor protection and the avoidance of regulatory arbitrage need to be firmly kept in mind.

Agenda item 5 | Agenda of the new Commission

As time was limited, it was decided that MPCP members would submit their comments in writing.

Agenda item 6 | CESR work programme

As time as limited, it was decided that MPCP members would submit their comments in writing.

1. Three topics related to the Takeover Bids Directive should be of interest:
   - equal treatment of shareholders: some regulators apparently no longer allow the exclusion of non-EU holders from takeover bids on the basis that this does not provide for equal treatment as required under the directive. Other regulators continue to allow for such exclusion if inclusion would lead to unreasonable burdens. CESR could try to find some common ground in these matters;
   - similarly, some regulators require the bidder who offers his own shares in exchange for the target company's shares to have the bidder's shares listed on an EU exchange and do not accept as sufficient that the bidder's shares are quoted on a non-EU exchange. It is unclear on what provision of the Directive such a requirement could be based. If this is not based on the Directive, than it at least creates an inequality that the Directive sought to eliminate;
   - the Directive is to be evaluated by the Commission in 2011. CESR could start evaluating the Directive from the perspective of the regulators and provide for an overview of remaining differences in the regulation of takeover bids and a view on the desirability of further eliminating these differences. In order to make a fruitful contribution to the Commission's work, CESR could already initiate this in 2010.

2. One possible result of the current financial crisis relates to the investment policies of certain institutional investors, such as pension funds. Some pension funds, notably APG and PGGM, among the largest in the EU, have indicated that they will revise their investment policy to hold a substantially smaller number of equity investments (they currently are holding between 4,000 and 5,000 equity investments globally and say that want to move to only 400 to 500 equity investments), the size of which investments would be substantially bigger, from 5-20% and which investments they intend to hold for longer periods of time. Such a move would have a significant governance impact and possibly provide for a much stronger basis for engagement by shareholders than is currently available. Such larger holdings, however, fundamentally reduce the liquidity of their holdings. As a result, these investors will in all likelihood only want to make such a shift if they have access to much more information than a regular investor would have. This raises the question in particular whether and under what circumstances the company can share price-sensitive information with such larger shareholders. Some regulators have allowed for discussions with larger shareholders under very specific circumstances, but not generally. If certain institutional investors would indeed change

their investment policies in this direction, the need for further clarification and a unified approach across the EU under the Market Abuse Directive is clearly needed. Such an approach would also have to include the various conceptions that exist on shareholders acting in concert, both in terms of notification duties under the Transparency Directive and in terms of the mandatory bid under the Takeover Bids Directive.

3. The European Corporate Governance Forum is working on establishing a solution for the problem of cross-border voting by shareholders. In short, the problem is that shareholders today typically hold their shares in securities accounts in book-entry trading systems. For the ability to identify themselves as shareholders they rely on securities intermediaries providing information of their holdings per the record date for voting. They may even require their help in the actual exercise of the voting right when by applicable company law the investor is not recognised as the formal shareholder entitled to vote. The Shareholders' Rights Directive did not solve these problems but work continues with securities intermediaries to find a solution. One of the concerns one might have is that it may not be possible for securities intermediaries to actually reconcile the holdings of each of their clients as per the end of business on every day. The whole record date system and voting by shareholders assumes that securities intermediaries are able to daily provide a confirmation (at the close of business) of what clients are entitled to what number of shares. One possible reason for the current inability of many of the intermediaries to do so may be that they engage in securities lending practices on a daily basis, which may complicate such reconciliation. This would certainly be the case if securities intermediaries lend and borrow shares held by their clients without their clients having authorised them to do so or to do so to that extent. This may jeopardise a practical solution for the problem of cross-border voting, but also for more general reasons (for example tax and insolvency) it would be unacceptable if securities intermediaries in the EU would be unable to daily reconcile the positions of their clients. The concerns raised, not altogether voluntarily, from the side of the securities intermediaries in the course of the discussions on cross-border voting do warrant further investigation and it would seem that CESR ought to be involved in such a process.

4. Some EU member states require that when securities are offered under an exemption of the prospectus obligation under the Prospectus Directive, nonetheless a selling restriction or warning is included. This is a form of gold plating. If CESR does not intervene it is likely that different Member States will start to require differently worded restrictions or warnings when such exemptions are being used. CESR could investigate whether the wording of such restrictions or warnings under harmonised exemptions could not also be unified, to avoid that in any offering a list of different exemptions or warnings is included for different Member States, all on the basis of one and the same exemption.

Agenda item 7| Any other business

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