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Summary

The MPCP met on 14 September 2010 in Paris to discuss the following issues:

- General overview of financial markets: MPCP members continue to be concerned about the situation in credit markets and consider that financial markets will need to compensate for the reduced lending activity in the banking system. In contrast to large corporates which have access to direct finance, SMEs, which have a key role in economic growth, are likely to be constrained in their funding. It was highlighted that, concerning the corporate bond market, there is a range of practices across Europe and that regulatory initiatives enhancing transparency would be welcome in this area to support the increased need for direct finance. Concerning CDS markets, it was stressed that, had fully fledged sovereign CDS markets existed before the debt crisis in Europe, the crisis would probably not have taken place because of the early warning function of CDS spreads. It was moreover pointed out that the role of high frequency trading (HFT) in the flash crash of 6 May 2010 is yet unclear and that regulators in Europe should have tools in place in order to enable them to know the nature of supervised entities.
- Concerning the European Commission's review of the Transparency Directive (TD), five issues were highlighted: 1) the extension to MTFs, whereas some MPCP members were in favor of such a measure in order to ensure a level playing field, while others argued that this would not solve the problem, and still others favored a threshold solution; 2) the dissemination of regulated information, where there was no agreement about the extent to which the absence of transmission by supervisors does or does not generate a "black hole problem" (as small companies have difficulties to convey their information to the market in a visible way) - an additional transmission channel through supervisors was nevertheless generally considered to be positive; 3) the modification of the notification thresholds, where some MPCP members favored harmonization, which should, however, take account of specificities by prescribing thresholds in terms of percentages rather than an absolute figure; 4) the trading book exemption, where MPCP members agreed with the position of CESR and asked for further clarification of the Directive; 5) empty voting, where some MPCP members stressed the serious nature of this problem and rejected any complacent attitude regarding this issue.
- "Retailisation", i.e. the marketing of complex products to retail investors, was considered inevitable by MPCP members, but it was also clearly recognised that the products often are not fully understood (either by retail investors or sellers), conflicts of interests are real, and the



potential for mis-selling is a key problem in this respect. The PRIPS initiative (Packaged Retail Investor Products), which has the aim of producing a template on product information for a wide range of products, is considered as promising. Transparency of fees should moreover be substantially increased. It was also proposed that the ability to sell complex products could be made conditional on the proven proper understanding of the nature of this kind of product. An alternative suggested would be product regulation with minimum standards. Also, a more harmonised approach focusing on best practices in terms of sanctioning regimes across Europe is needed.

- Market infrastructure issues were discussed on the basis of the White Paper published by the ICMA's European Repo Council, which stressed that there is no evidence of abusive behavior with respect to short selling, there are unresolved clearing and settlement issues in a number of markets which continue to create difficulties in the settlement of bilateral trades and also for electronically originated as well as centrally cleared trades in certain jurisdictions, there is an urgent need for action to remove the barriers to the efficient cross-border transfer of securities posed by the settlement infrastructure, and further progress in the clearing and settlement area is needed through regulatory initiatives like EMIR, as proposed by the EU Commission. Furthermore, it was indicated that ERC's last survey of the European repo market has shown that the market is back to pre-crisis levels. Ten firms accounted for over 68% of the total repo business and there is a broad underlying shift towards greater use of CCPs. The MPCP stressed the need to address CSD issues in a common framework across the EU, keeping in mind that there is a risk that mandatory CCP clearing which is too strict will diminish financial innovation, and that the right balance between an OTC market and CCPs needs to be achieved. Still open questions refer, for instance, to ownership, governance, risk concentration, and the nature of the platform. The debate in the U.S. on CCPs was presented as being very much driven by business opportunity considerations.
- Concerning the CESR/ESMA Work Programme 2011, comments made concerned the AIFMD, which was considered as a missed opportunity to build a single market for alternative investments.

The next MPCP meeting is scheduled for the afternoon of the 15th December 2010 at the CESR premises in Paris (instead of 16th December 2010).



Agenda item 1 | Update on market developments

MPCP members discussed market developments on the basis of some key aspects of an updated version of CERS's Report on Trends, Risks and Vulnerabilities in Financial Markets: evolution of the financial system; credit derivatives markets; flash crash; possible topics for future work streams of CERS's Committee of Economic and Markets Analysis (CEMA) - "retailisation" was only dealt with in passing as this was another agenda point of the MPCP meeting.

MPCP members made positive judgments concerning the CESR Report on Trends, Risks and Vulnerabilities, and stressed its objective reporting and the absence of political bias. During the discussion, the following risks and issues were singled out:

- The situation in credit markets continues to be strained despite low interest rates, and banks seem highly prudent currently in their lending activity. To compensate for this, recourse to financial markets is likely to continue to increase, should the current economic scenario be maintained. In the medium term, however, though its role in securitisation markets is likely to decrease, the banking sector could gain back some, but not all of its lost weight. Until then, SMEs, which are a key driver of economic growth, are likely to be constrained in their funding, given that direct market access is limited. Potential, but unlikely, ways to alleviate this problem would be the development SME private equity funds. Large corporates are less likely to suffer from funding constraints as they have the possibility to switch to direct finance. However, as far as the corporate bond market is concerned, there is a range of practices across Europe, particularly in terms of transparency which might sometimes be very low. Regulatory initiatives would be welcome in this area to support the increased need for direct finance.
- The changes concerning the Basel II Accord were deemed encouraging, even though they will take long to materialise. On the other hand, it was noted that the banking activity will become more costly, which in turn is likely to impact on the role the banking sector plays within the financial system.
- Concerning CDS markets, it was stressed that it is important to study the link between the CDS and the bond markets - had fully fledged sovereign CDS markets existed before the debt crisis in Europe, the crisis could not have taken place in the same way because of the early warning function of CDS spreads;
- Crashes like the quant crisis of 2007, where several among the largest and most sophisticated quant hedge funds experienced substantial losses within a limited number of days despite their market-neutral strategies, are likely to happen again. Crashes, including flash crashes, are a natural market phenomenon when they reflect fundamental information. However, the nature of the flash crash of 6 May 2010, and in particular the role of high frequency trading (HFT) in this event is yet unclear. Regulators in Europe need to have tools to enable them to be aware of the nature of trading of supervised entities. For Europe, certainly more data on HFT are needed. Moreover, HFT potentially poses significant risks to investors, for instance in terms of front-running. It was suggested that institutional investors be consulted about the role of HFT in financial markets. HFT was mentioned as a natural development in the sense that advantage is taken of existing technology; the distinction between the volume effect (which seems to be positive) and the impact on liquidity (which might be positive or negative) is key with respect to HFT as already highlighted at the previous MPCP meeting.

Agenda item 2 | Revision of the Transparency Directive

Concerning the European Commission's review of the Transparency Directive (TD), five issues were highlighted:

- 1) The extension to MTFs



Whereas some MPCP members were in favor of an extension in order to ensure a level playing field, others argued that this would not solve the problem as there will always be a less regulated market; still others favored a solution whereby regulatory requirements would be triggered by a threshold. Care should be taken to properly account for the nature of the activity of MTFs (e.g. both listing and trading or only trading; but also “fake trading”) and their evolution.

2) The dissemination of regulated information

Currently, the TD does not impose the transmission of information through a supervisory website, which is considered by some MPCP members as generating a “black hole problem” as, for instance, small companies have difficulties to convey their information to the market in a visible way. Therefore, regulation should play a role. Others, however, questioned the significance of the problem as the information is sought actively by investors, for example through internet tools. An additional transmission channel through supervisors was nevertheless generally seen as positive.

3) The modification of the notification thresholds

Some MPCP members favored harmonization, which should, however, take account of specificities by prescribing thresholds in terms of percentages rather than an absolute figure.

4) The trading book exemption

MPCP members agreed with the position of CESR and asked for further clarification of the Directive.

5) Empty voting

Some MPCP members stressed the serious nature of this problem (example of Treasury stakes), but also that it is difficult to tackle it from a legal perspective; they rejected any complacent attitude regarding this issue.

Agenda item 3 | “Retailisation” of risky/complex products

“Retailisation” can be defined as the marketing of complex products (originally marketed to institutional investors) to retail investors. Generally, their complexity includes the risk that these investors’ expectations about returns will not be met. MPCP members thought that the movement towards offering complex products to retail investors is natural and inevitable, but it was also clearly recognised that the products often are not fully understood (neither by retail investors nor sellers), conflicts of interests are real, and the potential for mis-selling should be considered a key issue. It was highlighted that investors in pension schemes are also retail investors whose lack of protection is a gap in the current regulatory landscape.

The following risks attached to complex products were underlined: intrinsic risk, legal governance and operational risk, due diligence risk (which is difficult to marshal by ordinary investors), behavioral risks (notably in the current low interest rate environment), informational asymmetries and suboptimal decision making, and last but not least, value destruction through the multi-layered relations between real and financial intermediaries. Some concrete examples of complex products were given like leveraged and reverse ETFs which are unsuited for the buy-and-hold strategies typically pursued by retail investors, or products involving baskets of shares with a very low probability to obtain the high returns advertised.

One high-level approach advocated was the “social utility model” which includes social objectives and adds an aim of long-term sustainability to the conventional risk-return trade-off in capital allocation. Concerning the profits generated by retailisation, it was stressed that hedge funds are careful to be very selective in their strategies, but also that academic studies have shown “high octane”-products do not necessarily lead to superior returns. Concerning different kinds of risk, like price risk and counterparty risk, there is no framework for the information to be delivered to customers and KID (the Key Investor Document) is clearly insufficient as complex products are not covered. The PRIIPS initiative (Packaged Retail Investor Products), which has the aim of producing a template for a wide range of products, is promising in this respect. In particular, transparency on fees should be substantially increased. Financial education was seen as one way to reduce the inevitable



informational asymmetries which are involved in the selling of risky and complex financial products, but limits in terms of outcome were recognised.

It was stressed that with respect to mis-selling, there exist substantial differences across Europe. Thereby, it should be kept in mind that there is a suitability requirement for the seller, conflicts of interests in the supply chain might be substantial, and mis-selling therefore has a reputational “boomerang-effect” which might somewhat contribute to alleviate the issue (though this was considered more likely in highly visible cases). It was recognized that CESR has a role to play in ensuring that products sold to retail investors are understood. Also, it was mentioned that a more harmonized approach focusing on best practices in terms of sanctioning regimes across Europe is needed. The approach by the Dutch AFM, which is based on the notion of the probability of realising a return which is higher than the risk-free return, was considered interesting, though it was also thought that is not always clear that retail investors understand the meaning of the risk indicator. Reference was also made to commodity-pools for which disclosure of the break-even point is required. It was also proposed that the ability to sell complex products could be made conditional on a proven knowledge of the nature of this kind of product. One suggested alternative would be product regulation with minimum standards. Against the background of the power of the new ESAs to ban products, it was questioned that all products sold should be submitted to a cost-benefit analysis (which is also not required for non-financial products), and it was suggested, fundamentally, not to put further constraints on selling.

Agenda item 4 | Issues in market infrastructure

MPCP members discussed market infrastructure issues on the basis of the White Paper published by the European Repo Council (ERC) of the International Capital Market Association (ICMA) on 13 July 2010. It was pointed out that a second ERC report is supposed to be made public towards the end of October 2010. The main results of the published report are as follows:

- there is no evidence of abusive behavior with respect to short selling; this is important for the repo market as it provides the borrowing facilities that support short selling;
- there are unresolved clearing and settlement issues in a number of markets which continue to create difficulties in the settlement of bilateral trades and also for electronically originated as well as centrally cleared trades in certain jurisdictions;
- Central counter parties (CCPs) have fails because of piping; as there is no fully integrated European framework, there is a risk of a bottleneck;
- the decision concerning the Basel initial proposal on prime collateral is likely to have an impact on the repo market;
- there is an urgent need for action to remove the barriers to the efficient cross-border transfer of securities posed by the settlement infrastructure;
- further progress in the clearing and settlement area is needed through regulatory initiatives like EMIR, as proposed by the EU Commission, but also through continuous work in the ECB-chaired COGESI working group.

Furthermore, it was indicated that ERC’s 19th semi-annual survey of the European repo market has shown that:

- the market is back to pre-crisis levels (record amount of EUR 7bn outstanding compared to EUR 6.8bn in June 2007) which represents a 25% increase with respect to the previous survey in December 2009;
- 10 firms in the survey accounted for over 68% of the total repo business;
- the market share of electronic repo trading continued to fall back, touching 22.5% compared with the high of 28.5% in June 2009;
- there is a broad underlying shift towards greater use of CCPs: the total share of surveyed repo business (electronic and non-electronic) cleared across CCPs was 22.4%, whereas most transactions are bilateral trades;
- the situation of the repo market is important to judge the extent to which systemic risk has decreased.



The MPCP discussion welcomed the report, and particularly the presentation on short selling was praised as a valuable input into the work by the European Commission. Concerning naked short selling, there was a recognition of risks – though this should not lead to a situation where that trading practice is regulated away. One proposal consisted in a distinction between the acceptable practice of short selling which includes the intention to settle the trade on the one hand, and the absence of an intention to settle on the other. A locate rule may be a solution in this case.

The need was stressed to address CSD (central security depositories) issues in a common framework across the EU. Concerning CCPs, positive and negative aspects exist. On the positive side, there will be improved regulatory oversight, better risk management, and, as a result, less operational risk. It remains, however, that only a small part of the derivatives market, i.e. about 20%, is cleared through CCPs. On the negative side, there continue to be systemic issues as a result of the risk concentration within the biggest banks if the OTC share is high, CCPs are expensive because of the high fees and the need for collateral (there is also too little collateral in the current system), and there is a risk that too strict a requirement concerning mandatory CCP clearing will diminish financial innovation.

Though reforms are under way with respect to CCPs, there are still some open questions: for instance, ownership (a user-owned solution would be considered inappropriate as competition would have positive effects) and governance issues (with the danger of a bank-friendly solution), the question of what and how much standardization is needed (here this discussion would profit from a dialogue between agencies and clearing houses), and the nature of the platform. The U.S. CFTC Chair has taken a position in favor of the exchanges. However, this leaves unaddressed the issue of documenting that trading has occurred.

Before discussing the debate on CCPs in the U.S. it was reminded that the new “Financial Services Oversight Council” will be chaired by the U.S Treasury and include the Federal Reserve Board, regulators/supervisors (the SEC, CFTC, OCC, FDIC, FHFA), as well as the new Consumer Financial Protection Bureau. It has the sole objective to identify and respond to emerging risk throughout the financial system. It makes recommendations to the Federal Reserve concerning prudential rules, with a special focus on companies which pose systemic risks.

As far as the CCP is concerned, the debate in the U.S. is very much driven by business opportunity considerations. Traditionally, clearing in a single place occurred in the area of securities trading, in contrast to the situation in the futures market where clearing was secondary. The strength of CCPs is the cross-product netting which leads to a reduction of risk and costs of capital (whereas cross-product netting is not possible in an OTC market).

One key problem is that liquidity is likely to dry up precisely when it is most needed. It was stressed that using turnover as an indicator of liquidity is misleading (e.g. market making can be considered “fake liquidity”). As far as HFT is concerned, the U.S. situation can probably not be entirely extrapolated. Halting HFT entirely was considered too extreme a position.

Agenda item 6 | Draft CESR Work Programme 2011

Concerning the CESR/ESMA Work Programme 2011, comments concerned the AIFMD which was considered as a missed opportunity to build a single market for alternative investments.

Agenda item 7 | Any other business

The Panel agreed to hold its next meeting on 16 December 2010 (now **removed to 15 December 2010**).