EUROPEAN COMMISSION

Brussels, 20.10.2011
SEC(2011) 1227 final

COMMISSION STAFF WORKING PAPER

EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT

Accompanying the document

Proposal for a

DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

Markets in financial instruments [Recast]

and the

Proposal for a

REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

Markets in financial instruments

{COM(2011) 656 final}
{SEC(2011) 1226 final}

1. PROBLEM DEFINITION

The Markets in Financial Instruments Directive (MiFID) establishes a regulatory framework for the provision of investment services in financial instruments (such as brokerage, advice, dealing, portfolio management, underwriting etc.) by banks and investment firms and for the operation of regulated markets by market operators, with respective powers and duties of national competent authorities.

The overarching objective has been to further the integration, competitiveness, and efficiency of EU financial markets. It abolished the possibility for Member States to require all trading in financial instruments to take place on specific exchanges and enabled Europe-wide free competition between traditional exchanges and alternative venues. It also granted banks and investment firms a strengthened "passport" for providing investment services across the EU subject to compliance with both organisational and reporting requirements and comprehensive investor protection.

Compounded by technological advances, after 3.5 years it achieved more competition between venues in the trading of financial instruments, and more choice for investors in terms of service providers and financial instruments. Overall, transaction costs have decreased and integration has increased. However, some problems have been identified.

1.1. Lack of level playing field between markets and market participants

The implementation of MiFID combined with the effect of technological advances has dramatically changed the structure of financial markets across Europe, notably in the equity space and made the conduct of market participants evolve to reflect these developments.

First, despite providing comparable services to regulated markets, MTFs may in practice be subject to a less stringent regulatory and supervisory regime. In addition, new trading venues and market structures, such as broker crossing systems and derivative trading platforms, have emerged that carry out similar activities to MTFs or systematic internalisers without being subject to the same regulatory requirements(transparency and investor protection).

Besides, rapid technological changes, in particular the growth of automated trading and high frequency trading (HFT) raise concerns about possible new risks to the orderly functioning of markets, even more so that not all HF traders are subject to authorisation and supervision under the MiFID.

Third, the growth of over the counter (OTC) trading on equities has led to concerns among some national supervisors about the quality of price formation on exchanges and its representative nature. In addition, G20 agreed to move trading in standardised OTC derivatives to exchanges or electronic trading platforms where appropriate.

1.2. Difficulties for SMEs to access financial markets

Small and medium-sized enterprises face greater difficulties and costs to raise capital from equity markets than larger issuers. These difficulties are related to the lack of visibility of SME markets, the lack of market liquidity for SME shares and the high costs of an initial public offering.

1.3. Lack of transparency for market participants

Some concerns have emerged that the transparency regime set out in the MiFID is insufficient for market participants in both the equities and non equities markets.

With respect to equity markets, the growth of electronic trading has facilitated the generation of dark liquidity and the use of dark orders which market participants apply to minimise market impact costs. However, an increased use of dark pools raises regulatory concerns as it may ultimately affect the quality of the price discovery mechanism on the "lit" markets. Market participants as well as supervisors have expressed concerns about time delays in the publication of trade reports in the equities markets.

For non-equity markets, transparency requirements are not covered by the MiFID and are only regulated at national level; these are not always considered sufficient.

In addition, there is the issue of the quality and format of the information, as well as the cost charged for the information and the difficulty in consolidating the information. If these issues are not fully addressed, they could undermine the overarching objectives of MiFID as regards transparency, competition between financial services providers and investor protection.

1.4. Lack of transparency for regulators and insufficient supervisory powers in key areas

In commodities markets, the increased presence of financial investors, especially in some key benchmark commodity derivative markets (e.g. oil and agricultural markets) may have led to excessive price increases and volatility. For derivatives and especially commodities derivatives there is no oversight of positions and their management that could prevent disorderly markets and investor detriment. The lack of clarity and consistency in the regulatory framework around emission allowances has negative impacts on market integrity and investor protection in the spot secondary market for emission allowances**.**

Existing transaction reporting requirements fail to provide competent authorities with a full view of the market because their scope is too narrow (e.g. financial instruments only traded OTC are currently not reportable) and because they are too divergent.

Experience, especially during the financial crisis has shown that there is a lack of powers to ban or restrict the trading or distribution of a product or service in case of adverse developments or limitations, as well as investigatory powers or sanctions.

1.5. Insufficient investor protection

There are a number of provisions in the current MiFID which result in investors not benefiting from sufficient or appropriate levels of protection. The consequences are that investors may be mis-sold financial products which are not appropriate for them, or may make investment choices which are sub-optimal.

First, there is an uneven coverage of service providers with some investment firms and some products, structured deposits for instance, not being or not clearly enough covered by MiFID.

Second, there are uncertainties about a number of services delivered to investors such the scope of execution only services, the quality of investment advice or the framework for

inducements. For the latter, the MiFID rules for disclosure on incentives from third parties have not always proven to be very clear or well articulated for investors.

Third, cases of mis-selling have created issues regarding the provision of services to non retail clients and classification of clients

Last, the lack of data on execution quality could impair the ability of investment firms to select the best possible venue for executing a trade for a client.

1.6. Weaknesses in some areas of the organisation, processes, risk controls and assessment of market participants

The problem presents two major dimensions. First, there is the insufficient role of directors and insufficient organizational arrangements for the launch of new products, operations and services and weaknesses in internal control functions, which has revealed by recent events. Second, there is the lack of specific organisational requirements for portfolio management, underwriting and placing of securities which have revealed by numerous complains from clients being registered in various Member States.

1.7. Obstacles to competition in clearing infrastructures

Developments in how EU trading venues connect with providers of clearing services have revealed and resulted in a series of obstacles to effective cross-border competition. While the merits and relative strengths of, on the one hand, vertically integrated trading and clearing platforms, and on the other, horizontally oriented clearing houses offering services to multiple trading platforms continue to be debated, these obstacles have hindered pan-EU competition at the level of trading platforms opened up by MiFID.

2. ANALYSIS OF SUBSIDIARITY

Most of the issues covered by the revision are already covered by the acquis and MiFID today. Further, financial markets are inherently cross-border in nature and are becoming more so. International markets require international rules to the furthest extent possible. The conditions according to which firms and operators can compete in this context, whether it concerns rules on pre and post-trade transparency, investor protection or the assessment and control of risks by market participants need to be common across borders and are all at the core of MiFID today. In some areas, where allowed by the Directive, Member States have already introduced stricter requirements. However, this means that they have only tackled the problems within their borders. Uncoordinated action would not achieve a level playing field and equal levels of investor protection / market integrity. Action is required at European level to update and modify the regulatory framework laid out by MiFID in order to take into account developments in financial markets since its implementation.

The European Securities and Markets Authority (ESMA) should also play a key role in the implementation of the new legal proposals. One of the aims of the creation of the European Authority is to enhance further the functioning of the single market for security markets; new rules at Union level are necessary to give all appropriate powers to ESMA.

3. OBJECTIVES

In light of the analysis of the problem above, the general objectives of the revision of MiFID are to strengthen investor confidence, to reduce the risks of market disorder and systemic risks, to increase efficiency of financial markets while reducing unnecessary costs for participants.

Reaching these general objectives requires the realisation of the following more specific policy objectives:

(1) Ensure a level playing field between market participants;

(2) Increase market transparency for market participants;

(3) Reinforce transparency towards and powers of regulators in key areas and increase coordination at European level;

(4) Raise investor protection

(5) Address organisational deficiencies and excessive risk taking or lack of control by investment firms and market operators

4. POLICY OPTIONS

The number of policy options which are considered in the revision is very substantial.

For the first general objective, the options cover the appropriate regulation of all market structures, factoring in the needs of smaller participants like SMEs, as well as the new trading technologies. This includes various reinforcements of the regulatory framework of existing trading venues, authorisation requirements and the possibility of creating a new category of venue, called organised trading facilities (OTFs) that would apply to the part of trading of equities currently done by Broker Crossing Systems (BCS) as well as for the trading of derivatives under different formats. Regarding specifically SMEs, the two selected options are to either introduce a tailored regime for SME markets or to promote an industry led initiative to enhance the visibility of these markets. On the technological side, the focus is on better controlling the users of these systems as well as the way they access markets.

Regarding the second general objective, the options to increase trade transparency include adjusting the current requirements for equities and setting up new requirements under different formats for non equities markets. In addition, several options are also considered to reduce the cost of market data and to improve the access to these data through a consolidated tape system.

For the third objective, the powers of regulators could be reinforced by introducing various measures such as an authorisation regime for new activities, a system of positions management and reinforcement under various schemes of the sanctioning regime. The harmonisation of conditions for third party regime could be done through various legal means while several options are also tabled for enlarging the scope of transaction reporting and improving the reporting channels used for this reporting. An area of specific attention is the commodity derivatives markets with the set up of different mechanisms to better control the volatility as well as the players on these markets and their activity.

Regarding the fourth objective, the reinforcement of the investor protection is made of several options focusing on specific areas of services like investment advice or complex products for which stricter framework and increased information request could be applied.

The last objective could be tackled through various policies dealing with the reinforcement of the corporate governance, stricter requirements for the organisation of specific services like portfolio management and a more harmonised regime for telephone and electronic recording.

5. ASSESSMENT OF THE IMPACT OF THE PREFERRED OPTIONS

The different policy options were tested against the criteria of their effectiveness and efficiency in achieving the related objectives. The comparison of policy options lead to the following conclusions:

For the first general objective, the first main preferred option is the creation of the OTF regime which has three objectives: (i) to set up an appropriate regulatory framework for broker crossing systems present in the equities markets, (ii) to set up an appropriate regulatory framework for different types of trading systems which are currently not regulated as trading venues, and (iii) to have a framework which is dynamic enough to accommodate the future trading systems and solutions that could emerge in the future. The second main preferred solution is the further regulation of firms conducting automated trading as well as market operators themselves, especially in terms of robust risk management and operational safeguards. Several options that would have restricted the activity of high frequency trading (HFT) with detrimental effects on market liquidity such as imposing a minimum period during which orders need to stay in the order book, have been discarded. Regarding SMEs, the industry led initiative has been discarded as too costly for its limited potential benefits.

For the second objective, the preferred option is a combination of the streamlining of the existing transparency regime in the equities markets with the introduction a tailor made transparency regime that will be calibrated to each type of non-equity financial instrument included (i.e. bonds and derivatives markets). This should strike the right balance between transparency and liquidity.

Regarding regulators' powers and consistency of supervisory practice, the main preferred option is a combination of the possibility of banning new services and products with a system of position management. This will reinforce the powers of regulators in order to address situations of risks on investor protection, market stability or systemic risk. In addition, the strengthening of the cooperation between regulators of physical and financial commodities markets will contribute to more orderly and stable commodity derivatives markets.

Regarding transparency towards regulators, the main favourite route is to combine extended scope of transaction reporting with better reporting through the set-up of Approved Reporting Mechanisms (ARMs) which will allow a much more extensive monitoring of markets by regulators leading to reinforced market integrity.

On commodity derivatives markets, a new system of position reporting with a review of the exemptions that some commodity traders were benefiting from will increase transparency towards both regulators and the public enabling them to better assess the impact of the inflow of financial investments on the price formation mechanism and the related price volatility.

Finally, the extension of the application of MiFID to secondary spot trading of emission allowances will ensure appropriate regulation and oversight of the spot carbon market and bring consistency in the regulatory framework between the physical and the derivatives markets and between the primary and secondary markets.

Regarding the fourth objective, the selected options will firstly enlarge the scope of regulation on products, services and providers and reinforce investor protection by ensuring proper coverage of investment services providers (i.e. small investment advisors currently exempt under MiFID will have to be subject to national analogous conduct of business rules) and products (i.e. structured deposits). In addition, the list of complex products which could be sold on an execution basis only would be narrowed down and information requirements towards clients would be reinforced. The option of totally deleting the execution only regime has been discarded as too disruptive and too costly for some categories of clients with good financial knowledge. And the quality of investment advice would be improved by specifying the conditions for the provision of independent advice. Finally the banning of inducements for independent investment advice and portfolio management will remove the inherent conflict of interests of the firms providing these services leading to a better quality of service for investors.

For the last objective, the preferred option is a combination of reinforcing the role of directors of firms, especially in internal control functions and specific organisational requirements in portfolio management and underwriting which are key areas for investor protection and market integrity while contributing to a more coherent framework in Europe. On the contrary, the introduction of a new separate internal function for the handling of clients' complaints has been discarded as too onerous and too inflexible.

6. MONITORING AND EVALUATION

The Commission will monitor how Member States are applying the changes proposed in the legislative initiative on markets in financial instruments. The evaluation of the consequences of the application of the legislative measure could take place three years after the transposition date for the legislative measure, in the context of a report to the Council and the Parliament. This could be based on various reports assessing the impact in practice of the various regulatory measures envisaged above.