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Developing Regulation in the Field of Financial Market Infrastructures

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Abstract

Securities markets' infrastructures are the subject of regulatory concerns, especially due to their systemic importance and their key role in investor protection. Different initiatives, both international as regional - esp. in the EU and in the US - have been introduced or announced. The present overview essentially deals with the European developments in the field of securities and in derivatives as well. Especially in the latter fields, reforms are urgently needed to reduce risk, introducing central clearing parties (CCPs), and trade repositories. The role of the European Securities and Markets Authority (ESMA) is especially mentioned.

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Key Note Address on Developing Regulation in the Field of Financial Market Infrastructures

Let me first start with pointing to some facts. During the financial crisis, the post-trade activities in the markets have not showed any clear shortcomings: according to my knowledge there were no interruptions nor collapses, and the systems you have installed and developed seem to have met the standards of resiliency and efficiency that you had promised. If there have been any problems, it mainly was at the post-default phase – Lehman collateral – or at the phase of trading – 6th of May. You have also been spared the shock waves of the Madoff fraud, where strict custody rules – at present in the AIFM – are likely to increase liability of custodians.

Another positive point, linked to the first is the high degree of automation that has been reached in the European markets. Thanks to this, markets have been able to function in a reliable manner and errors have been rare, at least in the post trade field. Although not unknown, fat fingers are not your primary concern! But further automation should be pursued, especially in the derivatives field.

All this does not mean that all is well and that there are no challenges that will confront you. There are still significant concerns in the cross border field for securities clearing and settlement, even within the EU, - where execution costs remain high -, there remain questions of interconnectivity between markets, interoperability being one of them, several of the Giovannini barriers are still in

place, in part due to the difficulty to adapt government regulations affecting this activity.

Robust financial market infrastructures make an essential contribution to financial stability by reducing what could otherwise be a major source of systemic risk. Moreover, insofar as Clearing institutions enable settlement to take place without significant counterparty risk, they also help markets to remain liquid even during times of financial stress.

An aspect that deserves ample attention are the private law underpinnings of trading in financial instruments: in the securities field, mention can be mention of the Unidroit convention, and more importantly of the Legal certainty group in the EU, that one hopes will come up with more harmonised – unfortunately not uniform - solutions for trading in securities. Some of its proposals will also increase competition, by insuring issuer choice of CSD, while others will even affect voting rights relating to securities deposited in a multi-tier system.

The entire field of post-trade with all its numerous ramifications is receiving ample attention from the regulators and supervisors. The European Commission is planning to publish its Green book on the European Markets Infrastructure Legislation, a comprehensive approach dealing with several aspects of the post-trade activity.

CPSS-IOSCO is actively working on the updated and integrated version of its 2001 and 2004 Recommendations for financial market infrastructures such as payment systems, securities settlement systems and central counterparties. The review is part of the Financial Stability Board's work to reduce the risks that arise from interconnectedness in the financial system. You remember that these recommendations were translated to the European context and were adopted,

after difficult and intensive discussions, into the European ESCB-CESR Recommendations. This experience is not likely to be repeated as this time there might be an adequate legal basis and clear mandate in the directive to translate these rules into binding European legislation. But again, some adaptation to the European context will be necessary as the factual situation in Europe is different from the American one, with several CSDs, some integrating the payment functions. Best practices and guidances will then be given at the level of recommendations, to be developed by ESMA.

Additional items in the European framework will relate to the points included in the Code of conduct, such as access to other Clearing and settlement organisations, disclosure of fees and prices, etc. Interconnection including STP will certainly be included after all the difficulties met in the past.

Another significant evolution is the ongoing work on Target 2 Securities that will constitute a typical European feature of the post trade securities market. This project is likely to reshape the settlement industry in Europe, bringing down the fees for cross border trading very significantly. It already affects the post trade business, but will affect trading as well, as under the best execution obligation, banks and brokers will be able, even more than before to compare trading opportunities on many trading platforms. Hence there's a need to ensure better pre-trade transparency and allow for intelligent systems that allow comparisons and efficient order execution. And I do not have to convince you that T2S will affect the business model of the CSDs and of their bank clients that may have to look out for new or additional sources of revenue.

Significantly, Europe has not chosen for the centralised American business model, by maintaining the different settlement venues and allowing competition among them. This will also be reflected in the structure of the post-trade market,

esp. T2S, and in the applicable regulation. We would prefer to see a sufficient degree of competition in this business, along with tight regulation.

It should be mentioned that CESR has a direct interest in the development of T2S, its members being responsible for the supervision of the feeders to T2S, i.e. the national CSDs. Therefore appropriate mechanisms for ensuring a dialogue between the market supervisors – preferably represented by CESR or ESMA - and T2S have to be devised, allowing both parties to achieve their objectives as part of their mandate.

I said already one word about the forthcoming legislation. One can expect it to contain harmonised supervisory requirements for CCPs. Requirements are likely to be related to the organisation (governance, fit and proper, business continuity,) conduct of business rules (admission of clearing members on the basis of objective, business related factors) but the main thrust will be on risk, risk management and mitigation. Among the tools considered, and apart from hard capital, are clearing funds, parent company support, loss sharing arrangements, insurance, and more on the operational side: margin requirements, hair cuts, highly liquid collateral requirements, all covered by a detailed disclosure requirements. And in addition, corporate governance requirements will be applicable, as has been mentioned in the Commission's Green paper, published yesterday.

The directive will also contain important (procedural) rules to materialize the (internationally desired) transfer of OTC derivatives to CCP-clearing. Important decisions will have to be made, both in Europe and in the US. Indeed as these markets are global, unilateral approaches will only lead to regulatory arbitrage. The European Commission, and also CESR are in close contact with the US

regulators, especially the CFTC and have been developing ideas that are largely parallel.

The issues to be dealt with in the derivatives markets are huge: the volumes traded on these markets indicate that they are undeniably systemic, the market structure and the transactions are not transparent, the complexity is considerable and realities are difficult to grasp due to strong and continuous innovation. Finally, most supervisors do not have extensive experience with this part of the business. So lots of work will have to be done!

Up to now, there is no clear opinion in Europe on how to implement the G20 agreement that "all standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate". The right answer is probably somewhere in the middle, i.e. that there is a bias in favour of trading on regulated market and this for purposes of reducing systemic risk, raising the issue of the criteria for eligibility. Systems have been worked out in the US with respect to clearing, based on the interplay between the regulator and the market to determine what should be subject to mandatory clearing. Whatever position we take here in Europe, it should not be in contradiction with what the US is applying. But in general, in Europe we are less adamant of trading on a regulated market, also because bespoke derivatives would be taxed more in terms of own funds on the basis of the CRD.

There is agreement that there is a need for more transparency at least at the level of post trade, and that they should to the maximum extent possible, be cleared through a central clearing house, or CCP. These CCPs are however causing some regulatory concern, as the risk concentration may be too high to be adequately dealt with. Alternatives as position compression should be investigated to see whether they offer similar and sufficient guarantees. The role

of CESR, or ESMA in this respect needs to be defined along with the roles of authorities licensing and supervising the functioning of the CCP and this in relation to the pre- and post CCP aspects. In the US these CCPs are supervised by the CFTC, but it is still open whether that pattern is preferable for the EU CCPs, due to different systems of fiscal support.

In the Post- CCP phase, the question arises whether one single Trade repository – for CDS in the US – is able to fill the needs of the European markets. Much depends on the function to be attributed to this TR. From the angle of trading credit derivatives, market participants plead strongly for the single TR for reasons of cost and efficiency. The ultimate decision is to be taken by the European legislator and we will see what the Commission will propose. From the angle of the supervisors the choice essentially depends on whether their supervisory needs are fully met. The recent events with the CDS on sovereign debt will be a significant test in that respect.

EU regulators should have full and unfettered access to the relevant information stored in TRs. In view of their importance for regulators (systemic, prudential or market perspective) TRs should be subject to registration. As TRs provide their services on a pan-European/global basis, ESMA should have a key role in the process for registration and surveillance of TRs. In any case, all transactions should be readily accessible to supervisors and this for supervisory purposes, including different forms of market abuse.

What will be ESMA's technical involvement in these matters? As from today ESMA will advise the Commission on forthcoming legislative proposals, whether on its own initiative or at the request of the Commission. This is already the case for issues relating to non-equity markets transparency and to the standardization and exchange trading of OTC derivatives, dealt with as part of

the Mifid review. But the advice will also relate to the trading aspects, the much-publicized "dark pools" and crossing networks. Discussions are planned for later this month. But it is likely that final reports will not be ready before the end of July, as part of CESR's Mifid advice.

In the future it is likely that the directive, or regulation as the case may be, will contain provisions that will allow implementing measures to be taken by Commission decision (compare the present level 2). Here normally ESMA will intervene in an advisory capacity, on the basis of the mandate issued by the Commission on the basis of a directive delegation. These regulations, called binding technical standards will be subject to a call back right from the Parliament and from the Council, most likely only when the Commission derogates from the advice of ESMA. Subordinate or "implementing" measures will be subject to a similar regime of MS scrutiny.

Another important point relates to the actual implementation of these measures. As these are EU regulations in the technical sense, they should be applicable in the national legal order, and national authorities are expected to implement them in their rulebook and in their actual practice. However, in case the national rulebook does not conform to the European rules or if the supervisory implementation is non compliant, ESMA will have the power to undertake action against the national supervisor in accordance with the proposed Article 9 of the ESMA Regulation. Some aspects are still unclear with respect to this enforcement process, especially as to the right of ESMA to undertake action against a non-complying firm, in case of non-compliance by the national supervisor with ESMA's decision. Furthermore, there are some indications in the proposals that have been circulated up to now that ESMA may even be the single supervisor for some matters that have a wide European application, as would be the case for the rating agencies. Indeed the European Council has

already decided that the supervision on the rating agencies should be exercised by ESMA, what seems logical due to the specific oligopolistic structure of this market. One can expect other matters to follow suit.

To conclude: there will be significant regulatory developments in the field of post trade and infrastructures. One will have to wait for the formal proposals of the Commission to have a clearer view, but it seems clear that the derivatives activity will call for most attention. This is logical due to the greater risk concentration in this business segment. In any case it will be crucial to maintain open communication and consultation lines between the industry and the regulators to achieve the best results both for the markets and in the public interest. I'm convinced that working together we will be able to construe a solid, resilient and efficient post trade environment in Europe.

June 3rd 2010 , Wolfsberg (CH)
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Financial Law Institute

The **Financial Law Institute** is a research and teaching unit within the Law School of the University of Ghent, Belgium. The research activities undertaken within the Institute focus on various issues of company and financial law, including private and public law of banking, capital markets regulation, company law and corporate governance.

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