Executive summary:

- In regulating markets to reduce systemic risk, considering the specifics of each sector and applying regulation accordingly is preferable to taking a “one size fits all” approach. This way, market efficiency and systemic risk reduction go hand-in-hand.

- This is true for movements towards organised trading platforms, product standardisation and CCP clearing of OTC products. It also goes for the imposition of pre- or post-trade price transparency. Similarly, regulation of short selling, because of the uncertain benefits for systemic risk reduction, should be implemented with caution.

- We favour the establishment of one global Trade Repository per asset class and full, immediate and coordinated transaction reporting to regulators to enable effective supervision. We caution against public transparency on the basis of its negative impact on liquidity and ultimately risk management.

- The Giovannini Barriers to cross-border post-trade processing of securities are a source of potentially systemic risks. While the industry has made good progress on many of the Barriers, the completion of this process will in most cases require public sector action.

- We welcome closer dialogue between regulatory bodies, policy makers and market participants. It is critical that market changes do not inadvertently introduce new risks into the system as a result of disjointed and counter-acting processes.

Market crises in recent years, whether from the credit crunch, general liquidity crisis, bank failures, or recent sovereign crisis, have led policy makers to consider how to address these market failures. Market reform, where appropriate, is welcome and AFME members support efficiency improvements in trading processes to restore confidence in the markets and reduce systemic risks.

The systemic risk profiles of Europe’s capital markets are to a significant extent determined by the structures and processes underlying them. The key elements include: the venues in which trading is carried out; the reporting and settlement of trades and the degree to which information is made public; the ability of regulators to have access to the data they need in order to monitor markets effectively while maintaining market participants’ confidentiality; and the degree to which products and processes can be standardised while still allowing for innovation.

“A ‘one size fits all’ approach may have a counterproductive effect on systemic risk”
Many of the recent developments in the trading, reporting and post trade processing of financial instruments have had a positive impact on systemic risk reduction and management. For example, some standardisation of processes and centralisation of clearing and reporting have been beneficial. However, there is a risk that if a “one size fits all” approach were applied to many aspects of this diverse market there may be a counterproductive effect on systemic risk. In this chapter, we set out our views on the existing reform proposals, both regulatory and market-led, note the areas in need of most urgent attention and offer suggestions that the authorities may wish to consider as they take their work forward.

Short Selling

The short selling of financial instruments is often cited by non-market participants as a cause of market instability and, therefore, risk. This is not the case. Short selling is a well-established trading activity, essential for market making and widely accepted by investors and regulators (e.g. IOSCO and CESR) as helping to enhance price discovery, counteract supply/demand imbalances and provide liquidity to the market in the relevant securities.

AFME is not aware of any evidence that demonstrates short selling contributing to systemic risks. Furthermore, observers such as the International Monetary Fund suggest that most of the adverse market movement in the recent crisis can be attributed to fundamental factors. The IMF sees short selling as “a symptom and not a cause of the problem”. It notes that short selling “can help mitigate market bubbles”. In this sense it could help reduce systemic risk, rather than cause it.

Private reporting to regulators will enable them to monitor adverse or market abuse behaviours, distinct from normal trading activities. Public disclosure of individual firms’ short positions would, however, be disproportionate and could be harmful. For equities, as an aide to greater market transparency, regulators may wish to consider publishing aggregated privately notified short positions.

Some fear the market will be disrupted by transactions where the seller has little or no intention of covering the sale and have argued that a blanket ban on uncovered short selling would mitigate this. This would be a disproportionate response to the small risk of non-settlement, and would negatively affect other selling and securities lending activity. Uncovered short selling can, in fact, have important benefits for the market as a whole, in terms of liquidity and investor confidence. The most appropriate way to discourage abusive uncovered short sales would be through the application of reasonable and consistently applied settlement discipline measures such as buy-ins, which would apply to any persistent settlement failure.

Regulators have, on occasions, deployed emergency powers to halt short selling in specific instruments. It is right that these powers should be available so that regulators may intervene to restore order and confidence in emergency situations. However, banning short selling in difficult market circumstances can increase stress and volatility and may actually serve to undermine confidence. Care is therefore needed when defining the circumstances in which emergency powers may be used.

Price Transparency

Deep, liquid and transparent markets are important criteria for effective risk management as they enable participants to access the capital markets for funding, hedging risks, and increasing or unwinding their positions with relative ease. A core element of the review of the Markets in Financial Instruments Directive (MiFID) is to improve the market further by increasing the availability of pricing information to market participants. AFME supports this. In our view, the optimal regulatory approach would take into account the following three key aspects when considering price transparency:

- promoting a thriving market place that enables wide participation and brings real benefit to the European economy;
- encouraging greater education and transparency for smaller institutions.

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1 E.g. IMF Staff comments on EU commission consultation on short selling; 5 August 2010, p 2-4.
2 Analysis suggests that public short selling disclosure requirements could reduce equity market liquidity by at least 25%. The Oliver Wyman report into: “The effects of short selling public disclosure regimes on equity markets” www.managedfunds.org/downloads/Oliver_Wyman_Financial_Services_Report.pdf
3 IMF study suggests that banning of (naked) short sales of financial stocks in September 2008 did relatively little to support the targeted institutions’ underlying stock prices, while liquidity dropped and volatility rose substantially. IMF Staff comments on EU commission consultation on short selling; 5 August 2010, Annex 3.
4. Market Infrastructure

without punitive impact on the wholesale marketplace; and

• **calibrating the balance** between protecting liquidity for market participants whilst also ensuring adequate transparency.

Any measures aimed at improving pre- and post-trade price transparency need to carefully counterbalance the impact these measures may have on dealers’ ability to commit capital and ultimately to provide liquidity. This is particularly crucial in times of stress when market liquidity plays such an important role. Without liquidity, participants’ ability to manage their positions is severely impaired, which will further exacerbate risks in the system.

The financial market comprises a number of very different asset classes and, as such, pre- and post-trade transparency requirements need to be appropriately calibrated to take account of these differences. Each instrument has its own distinct set of characteristics and, within it, varying levels of liquidity. The transparency regime for each should take into account:

• **Comparability of the instruments** – understanding the difference between standardised versus more complicated bespoke transactions. This is crucial in order to ensure price data provided is not misleading and enables users to compare “apples with apples”.

• **Liquidity of the instrument** – a number of factors impact the liquidity of an instrument, such as:
  - initial size of deal; trading volumes for the transaction; size outstanding; and whether instruments are on or off-the-run, especially in terms of contributing to a price-yield curve. Reporting liquid and illiquid transactions with the same measure will only reduce interest in the illiquid transactions, exacerbating the problem further.
  - **Complexity of the instrument** – these are factors that affect how quickly disclosure should be given to the market participants “outside” of a trade without punitive impact on those “in” the trade. Such factors include: complex pricing structures; bespoke or large transactions; the number of dealers customarily active in the instrument; and the time required to execute, hedge or unwind positions. All require suitably protective delays of, at a minimum, settlement period before disclosure to wider market participants.

Overall, transparency is to be welcomed where it benefits market users and comes at a cost proportionate to the benefits. Publishing data that is not used will cost the industry and, ultimately, the end user. Any additional dissemination of information should not add complexity and confusion for its users.

With little direct retail involvement in many asset classes, any measures to be proposed should take account of the overwhelmingly wholesale nature of these markets. Otherwise, liquidity (and risk management) could be damaged in an attempt to serve a class of participant that is not an active user of the product.

Finally, any new regime should consider the fluid nature of the market and begin with a phased approach to enable regulators and market participants to assess fully the benefits and impacts of each phase on the market place. Inadequate testing or review will introduce unintended costs and new risks to market participants.

A regime that fails to consider these factors (at a minimum) will fall short of the intention to promote a thriving market place, improve transparency to new or smaller market participants and protect liquidity in the market.

**Trading Venues**

In recent years the market has continued to see a growth in organised trading venues or “platform trading”, where specific instruments are traded automatically using technology that matches prospective buyers and sellers. The appeal of such platforms is that they are perceived as offering improved transparency, price formation, liquidity, operational efficiency and market access.

However, while the centralisation of trading may in certain circumstances facilitate transparency, liquidity and risk mitigation, this is not universally the case and, irrespective of the nature of the instruments traded or the parties trading them, the growth in platform trading may lead to an overall increase.
in systemic risk. The decision as to whether trading should be multilateral or remain bilateral is, therefore, not as clear-cut as it may seem and requires consideration of a number of factors.

Benefits cannot be attained through platform trading where there is insufficient liquidity or participation in a particular product to support effective platform trading. In many cases, bilateral trading, whether over-the-counter (OTC) or on bilateral trading venues, will remain an important method of negotiating trades, especially block trades.

There is a wide range of execution models for platform trading on offer, including single dealer platforms, multidealer platforms, inter-dealer brokers and exchanges. Some offer combinations of electronic services or traditional voice methods. We see all of these as complementary, attracting different users according to their requirements, and would be concerned to see all trading move to the exchange trading model. The nature of the liquidity and the type of market participation is critical in determining whether this centralised model of execution will be effective for a typically bespoke market such as derivatives. We believe, therefore, that allowing each market to select the most appropriate mode of execution would produce the best outcome.

While standardisation is a pre-condition for multilateral exchange trading, it is even more important that there is continuous liquidity and a number of participants with matching trading interests, enabling those interests to be matched without the need for an intermediary. The bond markets (which are characterised by a high degree of over-the-counter trading) illustrate that highly standardised instruments are not a sufficient criterion to ensure trading on exchanges. In cases where there is a relatively small number of professional market participants with different risk and investment requirements, there is likely to be a natural timing gap between the emergence of natural buyers and sellers, which makes the market less likely to gravitate towards exchange trading.

If multilateral exchange trading is mandated for markets that are naturally better suited to OTC trading, liquidity will, in fact, be discouraged. Intermediaries will no longer have the information obtained through market making that encourages them to supply liquidity and the reduction in the ability to manage risk will have consequential impact on the costs and competitiveness of end users of the markets, such as corporates.

In addition, platform trading can see order and transactions sizes decrease while the frequency of trades increases. However, these trends can also be signs of an inefficient market, as they can be the result of the unwillingness of market participants to perform effective risk transfer functions. Markets characterised by those features can also be more vulnerable to risks of the kind illustrated by the May 2010 “flash crash” in the US.

It is important to allow continued scope for innovation through the creation of new products and services. Even where products are traded on organised trading platforms, it must still be possible to trade them on an OTC basis. Many products, including equities, are traded both OTC and on exchange. For example, large blocks of shares are currently traded OTC for a number of reasons, such as confidentiality, inability of exchanges to process large stakes, etc. There would be no advantage in confining this kind of trading to an exchange, even though shares are completely standardised and completely fungible. Similar issues arise in relation to derivatives, where large institutional participants frequently trade in large sizes to hedge or manage risks. These trades are an essential feature of the market but cannot be handled through platform trading.

**OTC Standardisation**

While the standardisation of financial instruments can facilitate improved risk management, certain risks can be properly managed only through bespoke products.

Legal process and product standardisation can have significant benefits for minimising systemic risk. It can, among other things:
reduce operational risk by automating processes, which can also reduce cost;
facilitate bilateral and multilateral netting (reducing risks) and the transfer of risk to a central counterparty;
facilitate the use of electronic trading that improves price discovery;
facilitate bilateral and multilateral netting (reducing risks) and the transfer of risk to a central counterparty;
facilitate the reporting of information for regulatory purposes (which is discussed more below under transaction reporting and trade repositories); and
enhance contractual certainty, which is helpful in times of disputes between counter-parties.

When considering standardising OTC products, there are some important factors to bear in mind relating to the use of such products to hedge risk. These include:

- the legitimate need for bespoke products to hedge risks by, for example, needing to access variable rather than standard transaction sizes;
- the need to perfectly hedge risk where standardised products would expose the participant to basis risk;
- the imperfect match between the underlying and the hedge position will lead to the loss of hedge accounting treatment under applicable International Accounting Standards rules; and
- the need for a sufficient degree of product maturation in order to support drives towards greater standardisation.

Therefore, we need to consider three elements in relation to standardisation:

**Legal uniformity:** The industry strongly supports a move toward greater legal uniformity of derivatives documentation. Although there are strong incentives for the continued development of standard transaction documentation and definitions, there are also many circumstances in which it may be both preferable and legitimate to use non-standard documentation, so this should not be prohibited.

**Process standardisation:**
The moves to achieve greater process standardisation, including the greater use of electronic trade confirmations, should continue. Industry-agreed progressive targets play a very useful role in this regard. However, there is no case for requiring firms to use electronic trade confirmation services. The industry initiatives towards greater use of such confirmations have generated, and will continue to generate, very significant benefits, even if they do not achieve 100% coverage of all transactions. Mandating their use could well stifle the development of new products and services.

**Product standardisation:** Further product standardisation should be developed where it is driven by market needs and priorities, and takes into account product maturity, liquidity and customer requirements. Products do not need to be standardised to be liquid, as the market for foreign exchange (FX) products demonstrates.

There are limits to standardisation and firms should retain the flexibility to customise products. This applies as much to financial firms as to their clients. All market participants may need to create customised products and transactions for particular purposes, e.g. to pass risk between group companies. Requiring end users to adopt products that result in mis-matched exposures may well lead them to treat hedging as a source of profit rather than a risk management activity.

**Trade Repositories**
Regulators should have full access to trading information and Trading Repositories (TRs) provide a vital service in maintaining data on transactions. TRs can provide supervisors with various trade data, including client names, to enable them to develop a more complete view of OTC derivatives market activity and so enhance their ability to oversee the market and its participants. This is important in assessing risks by analysing the distribution of counterparty and market exposure across participants and aiding the timely detection of concentrated positions by any one participant or “crowded” positions in any one type of trade.

Their establishment should be encouraged, particularly in the case of derivatives, but to be most
effective, and to provide the required visibility, we favour the development of only one global TR for each asset class. The development of separate regional TRs could be damaging and counterproductive; the fragmentation of information that could arise could increase operational costs. More importantly, it would add to the risk of duplicative or omitted reporting of transaction information.

TRs support a global market and their operations should be structured to support a global supervisory community that is as internationally coordinated as possible. The role of TRs in systemic oversight makes it essential not only that they are operationally robust but also that there is no fragmentation of this function, since that would defeat the object of ensuring efficient aggregation of information by asset class. Fragmentation would also impose unnecessary cost and operational complexity and risk.

Where TRs exist, the issue of confidentiality – particularly of proprietary and customer data – is extremely important. Market participants’ support of particular TRs will be largely down to trust that their positions will be kept confidential. Breaches would severely undermine a market participant’s business and put it at a serious disadvantage to its competitors.

The laws relating to client confidentiality may differ from country to country and, at various levels, restrict the ability of banks and dealers to disclose confidential information to third parties. Global coordination on this point would be beneficial.

Transaction Reporting

Full, immediate and coordinated transaction reporting to regulators will enable effective supervision but public transparency will have a negative impact on liquidity and ultimately risk management.

Hence, while public transparency may not be desirable in many instances, full and immediate transparency to respective regulators, across all asset classes and jurisdictions, should be encouraged. The existing daily transaction reporting process in Europe is well-established and effective (although there is scope for discussion on the extension of the reporting obligations for some non-cleared OTC transactions). Daily transaction reporting is important for regulators as a means of monitoring market behaviour and identifying attempts at manipulation, although the current Transaction Reporting Exchange Mechanism (TREM) is not sufficient for the monitoring of positions for systemic risk purposes. Nor are the current trade repositories generally sufficient to handle daily transaction reporting as they generally report on a monthly basis.

A global reporting infrastructure would ensure regulators have a consolidated view of transaction reporting.

Duplication of reporting requirements and processes could be avoided. Reviewing the options for reporting infrastructure and implementation would also provide an opportunity for client confidentiality issues to be addressed.

OTC Clearing of Derivatives

The role of central clearing in OTC derivatives has been developing rapidly, having been initially applied to interest rate swaps in the late 1990s and subsequently to credit default swaps (CDS), as that market grew sufficiently large to support it. In such large, liquid markets, Central Counterparties (CCPs) offer an alternative way of managing “interconnectedness”, by means of risk mutualisation, and incremental efficiencies in exposure reduction through multilateral rather than bilateral netting.

However, the use of CCPs is generally not appropriate for bespoke and illiquid products. And for some asset classes, such as FX, it is debatable whether the costs outweigh the benefits, as settlement of these instruments is already efficient and safe. Indeed, the role of robust bilateral clearing as a means of reducing risk should not be overlooked.

In product areas where central clearing may be appropriate, the delivery of risk management benefits will depend on the relevant CCPs being properly capitalised and well-run institutions, as the market would be effectively
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In addition, OTC clearing must reflect the global nature of many of the products concerned. Where products from one region are cleared in another, CCPs must give full, equal access and transparency of information to all regulators as required. Otherwise, we run the risk of creating regional clearing models that will split liquidity, drive up costs and make it difficult, or even impossible, for regulators to capture a complete view of the market for systemic risk purposes.

**Post Trade Securities Processing**

In 1996, the European Commission brought together a group of financial market experts to identify inefficiencies in EU financial markets and to propose practical ways to improve market integration. These experts, the “Giovannini Group”, identified 15 specific obstacles, dubbed the Giovannini Barriers, to efficient EU cross-border clearing and settlement.

The Giovannini Barriers to cross-border post-trade processing of securities are a source of potentially systemic risks. While the industry has made good progress on many of the Barriers, the completion of this process will in most cases require public sector action.

To meet its longstanding commitment to a low risk, integrated and efficient post-trade securities environment for Europe, the industry continues to play a very active role in dismantling the Barriers. For example, it has developed, and is implementing, a comprehensive body of European market standards in the complex and high risk area of corporate action processing and is taking a leading role in joint work with the EC on a common securities settlement cycle for Europe. Substantive input and support has been provided to the public sector’s efforts to remove the Barriers for which it is responsible, including those relating to differences in the legal and fiscal approach of Member States to securities processing. Pan-European initiatives such as the T2S IT platform, designed to improve overall settlement in central bank money across the Eurozone and potentially beyond, are also welcome.

However, many Barriers (and potentially systemic risks) remain. For example, in the context of securities holding and disposition, the current differences between applicable legal regimes are a source of material legal uncertainty and operational complexity that significantly increase risk to intermediaries and investors. The continued existence of Barriers to harmonised settlement will undermine the ability of the T2S initiative to fulfil its risk reduction objective.

In the corporate action processing area, the current diversity of rules and regulations generate significant operational risks that in extreme cases can be of systemic proportions.

It is therefore essential that the process of dismantling the Giovannini Barriers is completed. This will mitigate systemic risks originating from or being exacerbated by a fragmented post-trade securities environment. We hope that, as they move forward with their work on market reform, public policy makers will also refocus on the Barriers for which they are responsible and provide vigorous support to market-led initiatives for their removal.

**Conclusion**

In summary, there are a number of initiatives underway which will continue to strengthen the markets and reduce systemic risk. Industry and regulators should continue to work together to achieve these goals. In this context, it is important to carefully consider each market sector in its own merit, as a tendency towards oversimplification of products and processes may ultimately undermine the mitigation of systemic risks.

Global TRs for each asset class are good tools for regulators to identify where systemic risk is building up in the system. Transaction reporting, while not generally a tool for managing systemic risk, provides regulators with the means to monitor markets and their participants. We favour measured increases in price transparency but not at the detriment of liquidity as that undermines the ability of participants to manage risk.

Standardisation of OTC products is a laudable goal as long as it does not
prevent participants from using bespoke products to hedge their legitimate risk. The clearing of OTC products is a positive development in managing risk for most standardised products provided the benefits are greater than the costs. This, however, does not necessarily mean that these products need to be put on an exchange.

Because of the lack of clear evidence that short selling contributes to systemic risks, we should ensure that this established market practice continues to function in an orderly manner. Emergency powers should be in place but used with great care. Finally, the long overdue removal of barriers to cross-border securities processing would help address potentially systemic risks and material inefficiencies and, in doing so, facilitate a single European securities market.

Further reading:
ICMA European Repo Council/ A white paper on the operation of the European repo market, the role of short-selling, the problem of settlement failures and the need for reform of the market infrastructure/ July 2010/ www.icmagroup.org/ICMAGroup/files/ac/ac9739eb-6c8b-4d0f-9f5c-d0f13e89bd8e.pdf
ISLA paper on short selling and securities lending, July/ http://www.isla.co.uk/uploadedFiles/Member_Area/General_Library/SECURITIES%20LENDING%20AND%20SHORT%20SELLING%20%283%29.pdf


Significant regulatory initiatives:
“Short Selling and certain aspects of Credit Default Swaps” http://ec.europa.eu/internal_market/securities/docs/short_selling/20100915_proposal_en.pdf