14 June 2013

European Parliament
Econ-secretariat@europarl.europa.eu

AFME response to the European Parliament Economic and Monetary Affairs Committee Questionnaire for the public consultation on enhancing the coherence of EU financial services legislation

Dear Sir / Madam,

The Association for Financial Markets in Europe (AFME) is pleased to respond to the European Parliament Economic and Monetary Affairs Committee Questionnaire for the public consultation on enhancing the coherence of EU financial services legislation.

We support and welcome the Committee’s examination of ways to enhance the coherence of financial services legislation. We believe this is a valuable and timely initiative in view of the large number of legislative initiatives launched since the 2007-2008 financial crisis. As the current European Parliament mandate enters its final year, it is the right time to reflect on the interaction between the different legislative initiatives. This consultation also provides an opportunity to take stock of what has been done to address the lessons of the financial crisis and what further work is needed to achieve a stronger and safer financial system.

As requested by the Committee, we have sought to support our analysis with concrete examples. We have not limited our analysis to adopted legislative acts and have drawn on various examples of proposals that are in the process of being debated by the co-legislators or developed by the Commission. We believe this is important as there are a number of ongoing workstreams that if wrongly pursued would be at odds with the Committee’s efforts to enhance the coherence of legislation.

We appreciate that EU legislators have had to manage two difficult demands: responding swiftly to the crisis and restoring confidence; and ensuring that such response is well-crafted, consulted with stakeholders and considered from different angles. We believe that the initial steps taken towards a Banking Union framework have been among the most significant and commendable efforts in this respect. Acting on a tight timescale and facing various legal challenges, the Commission produced a robust and comprehensive set of proposals for a European supervisory mechanism (SSM). The Council and Parliament have acted decisively in agreeing this major first step towards an integrated Banking Union
and we hope that further progress can be achieved on the other components of the framework. AFME is also very supportive of the prudential and systemic risk reform objectives underpinning the CRD IV and EMIR legislative packages.

In this submission we also draw attention to instances where we feel the desire to take additional actions to strengthen the financial system has led to a number of measures which cause concern among market participants. Some of these measures will affect market liquidity, and thus maturity transformation, at precisely the time when the Commission's Green Paper *Long Term Financing of the Economy* is exploring ways to enhance the capability of capital markets to compensate for the decline in direct bank financing expected as a result of new prudential requirements. Other measures are not considered high priority in strengthening the financial system and so are detracting political, regulatory and industry focus and resources from those regulations that are urgently required. We also believe that some proposed regulations have not benefited from rigorous impact assessments (nor cumulative impact assessments) and have generally been less well-conceived and articulated when compared with bank prudential legislation that has so far been put forward.

Accordingly, we have drawn four broad conclusions in conducting this exercise.

1. **Core European and global financial sector reforms**

The current EU legislative cycle (2009-2014) has been marked by the process of development and adoption of a range of vital, urgent reforms in response to the financial crisis of 2007-2008 and the more recent European sovereign-debt crisis. We believe that the core elements of the European reform of the financial system are constituted by: (1) bank prudential reforms relating to the CRD IV, Banking Union and Bank Recovery and Resolution Directive packages; and (2) capital markets reforms of derivatives markets through EMIR and MiFID/R as mandated by the G20 and reforms relating to financial markets benchmarks and indices.

These reforms are necessary; will provide the long term basis for recovery; and are critical to ensuring banks can be resolved without damaging financial stability and without recourse to public money.

Our first conclusion is that the appropriate finalisation and implementation of these stabilising reforms should be a priority for the last year of the 2009-2014 EU legislative cycle and should remain of primary importance in the 2014-2019 mandate.

2. **Non-core European level reforms**

We are less convinced by the priority, purpose and/or substance of other reforms. We refer in this consultation response to proposals including: (1) additional bank structural reform as envisaged by the Liikanen HLEG; (2) certain elements of the MiFID 2 / MiFIR package and regulations aimed at structured finance instruments; and (3) the proposed Financial Transactions Tax. Other initiatives that we believe
are non-core include proposals on data protection, Money Market Funds, amendments to EU securities law legislation and rotation of statutory auditors.

We believe that some of the time-consuming and highly-charged debates in these areas have little to do with financial stability, competitiveness and the sustainability of the European financial system. As explained in this consultation response, important aspects of these workstreams are in our view unnecessary, duplicative and inconsistent with the objectives of other reforms. Some of our most significant concerns on the coherence of legislation emanate from these reforms, which are either in the process of being adopted by the co-legislators or developed by the Commission.

Our second conclusion is to call on policymakers and the Committee to carefully consider the cumulative interaction between these potential reforms and what we believe are core reforms identified above. Policymakers should assess whether aspects of these non-core reforms: (1) duplicate policy objectives that have already been comprehensively addressed in other pieces of legislation; (2) are sufficiently high priority to warrant focus and resources from core reforms; and (3) are conducive to the objective of enhancing the resilience of the financial system and contribute to protecting investors, safeguarding liquidity and restoring economic growth.

3. Impact assessments and the policymaking process

In our third conclusion, we identify the strengthening of impact assessments and the policymaking processes important steps to improve the coherence of legislation.

A genuine impact assessment should involve a cost-benefit analysis of a given legislation incorporating an analysis of its interaction with other pieces of legislation. Impact assessments should be conducted by experienced research organisations independent from the institution proposing the legislation. It is critical that all proposals considered for adoption benefit from an impact study – including those tabled during the Parliament and Council readings. Due to the potential far reaching impact from such legislation on economic growth and financial stability, we would encourage the European Parliament and Council to regularly conduct their own impact studies and not rely solely on the assessments provided by the Commission.

A rigorous process for developing financial services legislation is of utmost importance. We would support measures that enhance:

- the articulation of concrete legislative objectives;
- the comprehensive assessment of the themes of this consultation: coherence of legislation, consistency of regulation and whether the objectives have been addressed elsewhere;
- the application of the principles of subsidiarity and proportionality; and
- the consultation process with stakeholders.
We note that prudential regulations that have been put forward since the crisis are having a stabilising and transformational effect on the industry. New regulations cannot therefore be looked at in isolation: their processes involve the additional demand of assessing overlap and consistency in relation what has already been proposed. We feel that this additional demand for careful assessment may not have been sufficiently emphasised in a number of proposals discussed in this response.

We would welcome including in the policymaking process the practice of consulting again where material changes are made to proposed legislation post-consultation where those changes impose additional material burdens on market participants.

We also draw attention to the importance of setting realistic policymaking timelines, including as regards the preparation of Level 2 outputs.

4. **Timescale of global developments and implementation**

Our fourth conclusion relates to the need for global consistency and coordination. We stress the continuing importance of an internationally coordinated approach to reforms in view of the global nature of the banking and financial services industries. It is important that EU legislation does not front-run issues still being consulted upon at a global level – i.e. the ideal sequencing should be global accord and then EU legislation. The impact of front-running other proposals is a potential patchwork of differently-defined requirements, different implementation dates, and different interpretations with which to contend. It is also important that EU regulation adheres to internationally-consistent practices where possible.

It is acknowledged that EU policymakers have focused efforts on this area and have raised awareness of the legal and operational uncertainty that firms could face where a global approach to regulation is not achieved. We believe the need to find common understandings on a range of cross-border issues – for instance in relation to the reforms on OTC derivatives markets – should be considered a continuing priority in the 2014-2019 mandate.

Yours sincerely,

Gerry Cross
Managing Director, Advocacy
The European Parliament’s Economic and Monetary Affairs Committee is launching a public consultation on ways to further enhance the coherence of EU financial services legislation. Given the transition to a single rule book in financial services across the EU and the EU legislator’s willingness to have “all financial markets, products and actors covered by regulation” it is increasingly important to ensure that legislation fits together seamlessly. The consultation will feed into a programme of reflection to determine future priorities for the remainder of this mandate and to inform the priorities for the incoming Parliament in 2014. All interested stakeholders, including academics and informed individuals, are invited to complete the Committee’s questionnaire by 12 noon CET on Friday 14 June and send it by e-mail to: econ-secretariat@europarl.europa.eu. All responses to the questionnaire will be published, so please do not send any confidential material with your response. Please make sure you indicate the identity of the contributor. Anonymous contributions will not be taken into account.

IDENTITY OF THE CONTRIBUTOR

**Individuals**
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Position:
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**Organisations**
Name of organisation: Association for Financial Markets in Europe (AFME)
Name of contact point for response:
Contact details:
Main activity of organisation: Banking and financial markets
Registration ID in the Transparency register (where applicable): 65110063986-76

QUESTIONS

1. Are there specific areas of EU financial services legislation which contain overlapping requirements? If so, please provide references to the relevant legislation and explain the nature of the overlap, who is affected and the impact.

Yes, there are a number of cases of overlapping requirements in areas of EU financial services legislation. The nature of the overlap can take different forms, which we consider in the examples below.

- Different pieces of legislation seeking to address the same objectives: We believe the CRD
IV, Banking Union and Bank Recovery and Resolution Directive packages form part of a complementary, carefully conceived set of measures to achieve safer and fully resolvable banks; Liikanen report proposals for structural separation create unhelpful overlap by seeking to address similar objectives with different measures; meanwhile the proposed FTT seeks to promote better regulated markets, an issue that is being addressed in MiFID 2 / MiFIR, EMIR and other pieces of legislation.

- **Different pieces of legislation regulating the same activity twice**: This can be seen in the duplicative requirements in the CRD 2 and CRA 3 packages regarding the disclosure of information on structured finance instruments.

- **One or more pieces of regulation featuring conflicting requirements and objectives**: We believe there are examples on the MiFID 2 / MiFIR framework and the proposed FTT where objectives risk running into conflict with one another.

We discuss these examples below. We appreciate that EU policymakers have sought to achieve a proportionate approach to regulation that balances different objectives – for instance making banks safer whilst ensuring they continue to take responsible risks in providing financing to the economy. In the examples discussed below we believe this balance is not being achieved, resulting in an approach that seems uncoordinated and duplicative. This may lead not only to inefficiencies and greater administrative costs, but also undermine important policy objectives.

**Structural reform of the banking sector in the context of the Liikanen report and its follow-up**

At the time of writing, the Commission is in the process of formulating proposals on the recommendations of the Liikanen HLEG. Notwithstanding the forthcoming debate on proposed requirements, we feel it is important and relevant in the context of this consultation to comment on the (potential) approach to implementing the HLEG recommendations.

A fundamental source of incoherence and duplication in our view is found when a given piece of legislation is seeking to address policy objectives that have already been dealt with in other instruments.

We are strongly of the view that HLEG proposals to mandatorily require banks to segregate their trading activities from other banking business would represent an unnecessary and damaging extra layer of banking sector reform. The overarching objectives that this proposal would seek to achieve – reducing the probability and impact of bank failures and thereby lessening significantly the risk of future taxpayer-funded bailouts – are being comprehensively addressed in three major prudential reform packages: CRD IV, BRRD and Banking Union. Other measures have also been taken to make the trading operations of banks less prone to fail, including the G20 / EMIR framework on the regulation of derivatives markets.

Indeed, we believe that the potential extra layer of reform is likely to increase the fragility of the European banking sector by reducing diversification benefits, thereby undermining the other reforms. Far from being a cause to the crisis, diversified business models and geographic footprints were a source of stability and provided much needed funding to the economy throughout the crisis.

**Structural separation and the creation of narrow-scoped European trading entities through a**
carve out from universal banks would threaten the ability of capital markets to assist in meeting European financing needs – another important policy objective – as the reduced role of universal banks in capital markets will not be compensated in the short and medium term by a higher capacity of viable stand alone entities. This would also reduce competition and exacerbate the too-big-to-fail problem by increasing concentration of investment banking activities into fewer bigger players.

Moreover, structural change is already taking place in response to market forces, new prudential requirements and through changes to business models which will result in a substantial reduction in the capacity of European banks to extend credit and provide other services (there are several recent examples within AFME's membership).

Rather than pursuing an overlapping set of banking sector reforms, a better alternative is to achieve full resolvability of banks, so that the continuity of critical functions is ensured and the "too big to fail" problem eradicated. The adoption of the BRRD will represent a crucial step in this direction. It allows for separation of activities that undermine a bank’s resolvability specific to a particular operating model / banking group whereas structural separation is a blunt tool that has high upfront costs without obvious incremental benefits to financial stability.

Financial Transactions Tax

We believe that the proposed FTT represents a case of regulatory overlap and inconsistency. This is because its stated or implicit objectives have either been addressed elsewhere or risk running into conflict with one another. We refer to the examples below.

- Tackling fragmentation in the single market: Far from achieving this objective, the FTT as pursued will exacerbate single market fragmentation and create an unlevel playing field for financial institutions, corporates and end users based within and outside the FTT-zone.

- To achieve better regulated markets: This objective is already being comprehensively addressed through the MiFID 2 / MiFIR, Short Selling Regulation and EMIR packages, among others.

- Supporting the economy: Although technically limited just to the eleven EU Member States taking part in the enhanced cooperation process, the proposed tax will in fact apply to an unprecedented number of transactions in the rest of Europe and beyond. As currently formulated, the tax will increase the cost of raising capital for Europe’s businesses and governments. AFME believes that the tax will have a negative impact on hedging transactions undertaken in order to manage risk. This is because it will no longer be cost effective for firms to conduct their risk management activities within the FTT economic zone. Financial institutions will find it more difficult to hedge their own books and to provide liquidity to the market, especially for those banks that cannot relocate their treasury activities outside the FTT economic zone.

- To ensure that the financial sector makes a fair and substantial contribution to public finances: The overall additional costs of the FTT will ultimately be borne by end users. The proposed FTT will significantly impact the returns of long term investors such as insurance companies and pension funds. Financial markets cannot be ring-fenced from the rest of the
economy. Contrary to the assumption in the FTT proposal that primary issuance and secondary markets can be separated, declines in secondary market prices or increases in yields will in fact directly translate to increased costs to issuers and decreased portfolio values for investors.

- To raise revenue: The achievement of this objective is called into question by analyses looking at the economic impact and the risk that the imposition of the FTT actually reduces total tax revenues from the economy\(^1\).

- To support financial stability: AFME believes that the proposed FTT would run counter to the objective of reinforcing financial stability. For example, in light of the CRD IV agreements it should be noted that market liquidity in instruments issued in the participating countries will drop compared to issuance in non-participating countries. This could result in making compliance with the Liquidity Coverage Ratio for banks, and especially those resident in the 11 participating countries, more challenging. The FTT proposals also go against the regulations under EMIR with regard to clearing derivatives. Whilst CCPs will be exempt from paying the FTT, the bank counterparts in the trade with the CCP will not. Finally, we are of the view that the FTT provides incentives for banks to turn to the European Central Bank for repo-lending rather than to other financial intermediaries, which goes against reducing banks’ reliance on lender of last resort lifelines procured by central banks.

**Amendments to Regulation 1060/2009 on credit rating agencies (“CRA 3”) and EU Capital Requirements Directive 2009/111/EC (“CRD 2”)**

A case of regulatory duplication is found in requirements concerning the disclosure of information on structured finance instruments under the CRA 3 package and the CRD 2 text currently in force that may potentially undermine an important policy objective: the revival of a sound and sustainable securitisation market.

AFME’s concern is that overlapping and inconsistent disclosure requirements, supervised by separate EU regulators and subject to differing technical standards, data definitions and regulatory interpretations, will make consistent disclosure almost impossible. It will create significant legal, compliance and regulatory uncertainty for market participants and potentially create confusion for investors. In turn, this is likely to diminish, rather than enhance, investor confidence.

Article 8b of CRA 3 seeks to impose an obligation not on CRAs, but on “the issuer, originator and the sponsor of a structured finance instrument ... [to] disclose to the public ... information on the credit quality and performance of the individual underlying assets of the structured finance instrument ...” It is not clear why Asset Backed Securities (ABS) disclosure is to be regulated via the CRA Regulation.

Disclosure of information on structured finance instruments is already mandated in the revised EU Capital Requirements Directive (CRD 2) which came into effect in the European Union on 1 January 2011. This provision asks sponsors and originator institutions to ensure that prospective investors have readily available access to all materially relevant data on the credit quality and

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performance of the individual underlying exposures, and cash flows and collateral supporting a securitisation exposure as well as such information that is necessary to conduct comprehensive and well informed stress tests on the cash flows and collateral values supporting the underlying exposures.

Disclosure of loan-level information and other data is also a condition of participation in the various funding schemes of the ECB and the Bank of England. The Prospectus Directive has for many years also provided the underlying legal framework for disclosure of material information for investors, in both structured finance instruments and securities more generally. It is not clear whether loan-level information would be required to be disclosed under the new CRA 3 requirements. If such information is required, this will present heightened issues, particularly if the reporting standards are inconsistent with those applicable under the existing central bank initiatives.

It is essential that a consistent approach is adopted with respect to ABS disclosure. An uncoordinated approach will result not only in unnecessary burdens for issuers and investors alike but also in confusion defying the objective of transparency, and ultimately may act as a disincentive to securitisation issuance. IOSCO highlighted this danger in its Final Report on Securitisation published towards the end of last year. Much work has been done by the securitisation industry to repair its reputation which was damaged by the US sub-prime crisis, and European policymakers increasingly acknowledge the need for securitisation to play a greater role in financing the real economy and helping to restore growth. In this respect, we stress the positive contribution to the objectives of transparency, simplicity and quality the PCS initiative has yielded in the area of European securitisation.

**Review of the Markets in Financial Instruments Directive (MiFID 2 / MiFIR)**

MiFID/R is a complex piece of markets legislation with objectives supported by AFME: enhanced transparency, improved price formation, a level playing field in the Single Market, increased fairness and investor choice.

These objectives are complementary and the challenge lies in ensuring that a balance of objectives is achieved. This can be difficult as market participants may have different interests and therefore emphasise the objectives of some provisions over others. What is important is that an overall balance of objectives is preserved so that market participants can adjust to a sound framework that accommodates the different trading and supervisory needs. An orderly market functioning benefits all participants.

By way of example, whilst overall market transparency is essential to all participants, institutional investors seeking to execute large trades require provisions that protect them from adverse impact if their orders are signalled to all market participants. These provisions need to be carefully established whilst ensuring that they are not abused and that the market transparency objective is not compromised. The blanket pre-trade transparency obligations for non-equity markets included in the Commission’s proposals of October 2011 are considered unbalanced and not reflective of the way these markets operate. Parliament and Council have made some progress in designing a pre-trade transparency regime that is potentially better calibrated than the original proposal.
MiFID 1 contains a robust investor protection framework, including the overarching principle of best execution, which we consider to be a cornerstone of the MiFID investor protection.

The strict application of the full rigours of the investor protection framework (including the best execution principle) in our view provides the necessary safeguards to protect investors and ensure brokers always act in their best interests. Whilst the proposed MiFID 2 / MiFIR regime retains this body of investor protection provisions (and indeed, builds upon them), the Commission proposals of October 2011 and subsequent debate in Parliament and Council have seen the introduction of a number of proposals that we believe may negate from the broker's ability to act in accordance with their client's best interests and therefore, overall, are inconsistent with the best execution principle.

- Proposed equities transparency regime and severe constraints on the possibility to use the reference price waiver (in Council): Removing or excessively constraining this waiver runs contrary to the interests of investors, as expressed in the public positions papers of Pensions Europe and the European Fund and Asset Management Association. AFME has argued that in order to adopt a balanced approach in this area, regulators should continue to carefully monitor the market and develop market-specific benchmarks to better assess the health of price formation, as well as prioritise the establishment of a single consolidated tape to addressing the current fragmented provision of post-trade information.

- The proposed ban on the operator of an Organised Trading Facility (OTF) from trading against its own capital (in the Parliament and Council): A more balance approach could in our view be achieved by allowing for operator capital deployment when requested by the investor to ensure best execution and introducing conflicts of interest and client facilitation rules to mitigate any concerns about neutrality.

- Proposal to force OTC trading to take place on venue and/or under Systematic Internaliser (SI): The balance among trading categories would be unsettled if OTC is not conceived as a residual category for any trading not taking place on a trading venue or with an SI. The possibility to trade OTC is needed to ensure that trading in tailored, illiquid instruments does not disappear because it is made subject to transparency rules designed for liquid instruments.

2. Are there specific areas of EU financial services legislation in which activities/products/services which have an equivalent use or effect but a different form are regulated differently or not regulated at all? If so, please provide references to the relevant legislation and explain the nature of the difference, who is affected and the impact.

Yes. We refer to the examples below.

Risk retention and due diligence for structured finance instruments: lack of consistency across different types of investor and geography; see Article 122a of CRD (to be consolidated into the CRR), Article 135 of the Solvency II Directive and equivalent
provisions of the Alternative Investment Fund Managers Directive (AIFMD”) and UCITS Directive

EU authorities have made it clear that it is intended that similar retention and due diligence requirements should apply in respect of the securitisation investment activities undertaken not just by credit institutions but also by other types of European regulated investors, including insurance and reinsurance undertakings, UCITS and AIF managers. In keeping with this, the Solvency II Directive includes a general 'placeholder' provision which contemplates the adoption of implementing measures setting out the details of the requirements which should apply in respect of insurance and reinsurance undertakings. The AIFMD, which regulates managers of entities or arrangements that fall within the widely defined term “alternative investment fund” (AIF) (including hedge funds and private equity funds) includes a similar placeholder for rules to be made in respect of those AIF managers that are required to become authorised under the AIFMD. Provision is also made in the AIFMD for amendments to the UCITS Directive to insert the same placeholder for rules to be made in respect of UCITS.

While it was understood that the rules for AIF managers would necessarily differ from the requirements which apply to EEA regulated banks under the CRD in certain limited respects given the nature of such managers (e.g. the penalties for breach, discussed further below), it was hoped that the provisions would otherwise be the same. In particular, consistency between the regimes is desirable given that, in general, the market has found a way forward under the CRD requirements and also to ensure that originators and sponsors are able to efficiently structure relevant transactions to be compliant for all relevant regulated investors. While the final rules are much closer to Article 122a of the CRD than the original proposals under the AIFMD (and helpful general confirmation has been provided that the rules are to be interpreted consistently with the guidelines which apply in respect of Article 122a), key differences remain.

In particular, the due diligence requirements contemplated by the final rules for AIF managers differ from the CRD provisions in a number of important respects. Unlike Article 122a, the rules will require AIF managers assuming exposure to the credit risk of a securitisation on behalf of one or more managed AIFs (e.g. as investor or lender) to confirm certain matters with respect to the asset underwriting, administration and risk management policies and systems of the originator and sponsor.

Oddly, it appears that the relevant provisions in this regard have been adopted from requirements imposed directly on EEA regulated credit institutions in their capacity as originator/credit-grantor under the CRD (i.e. via Article 122a(6) and Annex V of the CRD), without acknowledgement of: the significant practical constraints on the ability of third-party investors to make the necessary assessments and confirmations; the potential limited relevance of such matters with respect to the specific securitisation position being invested in; and/or of the fact that, to the extent that the transaction involves an EEA regulated bank originator, such originator will itself be required to comply with the overlapping CRD requirements and to satisfy its national supervisor of this.

In this regard, we note that it is not clear that all aspects of the necessary assessments would be transaction and/or asset-type specific (i.e. in certain respects it appears that they are intended to relate to the standards and systems of the originator in general) and, given the wide manner in which the requirements are framed, there is some uncertainty with respect to whether the
information required to perform the required assessments would be publicly available (i.e. certain information may be commercially sensitive and/or subject to restrictions on disclosure). Difficulties may also arise to the extent that the relevant transaction does not involve an entity which clearly falls within the definition of originator or sponsor.

On other fronts, we note that, unlike Article 122a, the stress testing requirements under the final rules for AIF managers indicate that such testing shall only be required where an AIF manager has assumed exposure to a “material value” of the credit risk of a securitisation on behalf of one or more AIFs. Material value is not defined for these purposes. In addition, no reference is made to the use of rating agency financial models (although this is referred to in the existing guidelines under Article 122a\(^2\) and so may remain available given that the same guidelines will apply to interpret the final rules).

AIF managers are also expressly required to ensure that there is an “adequate level of internal reporting” in respect of securitisation exposure activities. Certain other due diligence requirements applied to AIF managers pick up on and cross-refer to general liquidity and risk management requirements under the AIFMD.

With respect to penalties, whereas the CRD penalties for breach of the requirements which apply to EEA regulated bank investors refer to the application of a higher regulatory capital charge with respect to the relevant securitisation position held by the investor, the final rules for AIF managers take a different approach owing to the fact that the AIFMD does not provide for a regulatory capital framework.

In particular, the final rules indicate that, where retention non-compliance is discovered after the relevant investment activity, an AIF manager is obliged to “take corrective action as is in the best interest of the investors in the relevant AIF”. A recital to the Level 2 regulation indicates that such corrective action may include "hedging, selling or reducing the exposure or approaching the party in breach of the retention requirement with a view to reinstating compliance" and "should not involve any direct obligation to sell the assets immediately after the breach has become apparent, therefore avoiding a 'fire sale'". The consequences of a breach of the due diligence and disclosure-related requirements by an AIF manager are not specified.

The due diligence differences outlined above may result in certain compliance challenges for market participants seeking to ensure that transactions are eligible investments for the full range of relevant regulated investors. Moreover, concerns have been raised that the due diligence requirements described above to be undertaken with respect to sponsors and originators are disproportionately onerous will discourage non-bank investors such as AIFMs from investing in structured finance instruments.

**Post trading services and open access to market infrastructures**

Throughout the current MiFID 2 / MiFIR debate policymakers have consistently stressed the importance of fair competition and rules that ensure a level playing field among trading venues in the single market.

\(^2\) Note that these are about to change materially, see below and the EBA consultation on RTS in this regard.
The same principles may not have been consistently applied to the area of post trading services. Post trading services are of equivalent importance to trading venue requirements to market participants. To provide a competitive alternative to an existing trading venue (including its clearing arrangements), a new entrant venue must do more than just provide the ability to trade an in-demand security or derivative: it must also offer its customers combined trading and clearing costs comparable to those of the existing venue. For this reason AFME has supported proposals that ensure non-discriminatory access by trading venues to central counterparties (CCPs).

The 2001 Giovannini Report identified the lack of competition between post trade service providers as a source of material costs to investors, concluding that inefficiencies in clearing and settlement represent the most important barrier to integrated financial markets in Europe.

The Commission’s MiFID 2 / MiFIR proposals of October 2011 have sought to address this long standing lack of competition. However, the ongoing MiFID 2 / MiFIR debate in Parliament and Council has seen proposals to dilute open access provisions. In our view, such proposals constitute an example of services receiving a protectionist treatment, different to the competitive and level playing field approach that forms the basis of the single market. AFME has provided ample analysis on the benefits of the competitive model to help diversify the sources of trading liquidity and mitigate the risks of CCP monopolization, in addition to reducing the cost and improving the quality of trading and clearing services.

Recovery and Resolution of Financial Markets Infrastructures (FMIs)

We note that the current proposed Bank Recovery and Resolution Directive deals with banks rather than Financial Markets Infrastructures. However, under the current proposed Central Securities Depositories Regulation (CSDR) some CSDs may be able to offer certain types of banking services. It is not clear therefore under which regulation they would fall should one default (i.e. should the ICSD in that instance be subject to a recovery and resolution regime of FMIs, which is yet to be determined, or should it be subject to the BRRD based on its banking services?).

3. Do you consider that the way EU financial services legislation has been transposed or implemented has given rise to overlaps or incoherence? If so, please explain the issue and where it has arisen, giving specific examples of EU financial services legislation where applicable.

Yes. We refer to the specific examples below.

Risk retention for structured finance instruments: Article 122a of the CRD, the CEBS Guidelines and EBA Q&A, and the EBA consultation on RTS re equivalent provisions of the CRR

A clear example of incoherent implementation is found in the area of risk retention for credit institutions who invest in structured finance instruments: Article 122a of the CRD (being consolidated into the new CRR).

Article 122a required mandatory retention of at least 5% of the risk of a structured finance from 1st January 2011. “Originators, underwriters or sponsors” were required by law to retain “skin in
the game” to ensure their interests were aligned with those of investors.

As nearly all European structured finance instruments already included the retention of at least this amount of risk by (usually) the originator, this principle was unobjectionable, and supported by AFME and its members. However, the text of the legislation was unclear in many areas and therefore detailed guidance was required; this was issued in the form of the “CEBS Guidelines” of 31st December 2010 and the subsequent “Q&A” issued by CEBS’ successor, the EBA, in September 2011. This provided market participants with much needed clarity about the scope and application of the rules, and how to comply3.

The text of Article 122a is now being consolidated into new provisions of the CRR. No material changes to the legislative text have been made. However, the EBA has issued a consultation on new RTS in this regard. If implemented as proposed, these RTS will remove key aspects of the existing all-important guidance provided by the CEBS Guidelines and the EBA Q&A creating uncertainty for market participants, complicating the structuring of transactions and making it more difficult to issue the legal opinions required by investors and rating agencies. Banks are important investors in structured finance instruments; if they are no longer able to invest because of uncertainty in how to comply with risk retention rules, this will further hamper any recovery in the European securitisation market.

The implications of the falling away of the CEBS Guidelines and the EBA Q&A may also have further implications for AIFs, the legislation for which also relies on this guidance (see response to question 2 above).

**Short Selling Regulation Buy In Rules**

Under the Regulation, Article 15 states that procedures should automatically be triggered for the buy-in of shares if the seller is unable to deliver within 4 business days, and for failing trades, a daily payment which is sufficiently high to act as a deterrent shall be established. There was no referral to ESMA for Level 2 procedures or consultation as to the method by which the buy-ins should be executed nor the level of a sufficiently high daily payment. This resulted in one CCP (responsible for collecting the payments and imposing the buy-ins) setting a unilateral, arbitrary daily payment for fines which all CCPs duly followed. There was no assessment to determine if this was the correct level by authorities. The buy-in process is handled in different ways by different CCPs. The Regulation was an opportunity to ensure that all markets acted in a harmonised fashion. AFME is now on behalf of its members working hard with CCPs to ensure a more consistent process, however this will be sub-optimal compared with a more considered regulatory regime.

Another example of a current potential overlap/incoherence of regulation is found in provisions under Article 15 of the Regulation which relates to any cash equity transaction cleared via a central counterparty and identifies penalties for late delivery and a buy in of failing trades.

The CSD Regulation, currently under discussion by the Irish Presidency, also seeks to implement buy ins and penalties for unsettled trades (Art 6 & 7). This is presumably aimed at trades that are not cleared via a central counterparty. However, there is a real possibility that trades could be

3 Although some difficult issues remained outstanding for some asset classes such as CLOs and CMBS.
penalised for late settlement under both regulations, once by the Central Counterparty (CCP) and again by the Central Securities Depository (CSD). We find it difficult to believe that this was the intention of either Regulation. Ideally, the Short Selling Regulation provisions would be included in the CSD Regulation so that it is clear which infrastructure should be responsible for the fining regime.

Additionally, under the Short Selling Regulation, CCPs are able to retain an element of the penalties as revenue. We feel strongly that fines should be passed back to the aggrieved party. Consideration has been given to this aspect in the CSDR.

4. How has the sequence in which EU financial services legislation has been developed impacted your organisation? Please identify the relevant legislation and, where applicable, specific provisions and explain the nature of the impact.

We discuss below the impact that the sequence in which EU legislation has been developed is having on the banking and financial services industry.

Bank prudential legislation

Banks are undergoing a significant process of adaption to new capital requirements and other regulatory and market developments. As discussed under question 1 above, mandating further structural reform at a time of such transformation would seem premature and potentially counterproductive.

The final impacts of the regulatory change to bank business models are not yet known as the interactions and final rules are still somewhat unclear due to the substantial powers given to the EBA. An example of this is the LCR liquid asset buffer and how it interacts with the forthcoming leverage ratio. Depending on the final leverage design of the leverage ratio, the leverage gap may incentivise firms to hold low returning liquid assets and a substantial portfolio of high risk assets to achieve a blended rate of return that is acceptable to the shareholders. Thus potentially forcing organisations to choose higher risk business strategies instead of preventing them.

EU legislation should not front-run issues still being consulted upon at a global level – i.e. the sequencing should be global accord and then EU legislation.

Examples where this has not been the case include:

- Large exposures being consulted upon in BCBS 246, and yet a number related requirements being included in CRD IV (e.g. in CRR Article 443a(3x));
- Measures targeting shadow banking being consulted upon globally and in Europe, and yet attempts to include some related measures in CRD IV;
- Reconsideration of the NSFR liquidity ratio at a global level, and yet many aspects of an NSFR measure being included in CRD IV (e.g., Article 414 and 415).

The impact of front-running other proposals is a potential patchwork of differently-defined requirements, different implementation dates, and different interpretations with which to contend.

Capital markets legislation
There have been a range of regulatory initiatives which we believe fall short of well articulated and integrated objectives and effective impact assessment. We refer to three concrete examples:

- The proposed Financial Transactions Tax and its effect on financial markets (see our comments under question 1);
- Elements of MiFID 2 / MiFIR (see our comments under question 1);
- The ESMA Guidelines for the implementation of the Short Selling Regulation.

Although the full impact of these reforms is yet to be felt, they are likely to have an important negative effect on market liquidity, funding costs and risk management activities. Please also refer to our comments under question 10 on the impact of these pieces of legislation on market liquidity.

**Short Selling Regulation**

We refer to the challenges posed by the sequencing of the implementation the Short Selling Regulation.

The Short Selling Regulation came into effect on the 1 November 2012, however ESMA had not finalised its Guidelines on the exemption available for market making and primary market operations. In fact these Guidelines will only take effect from the 2nd June 2013 (after being published in February 2013).

AFME was very concerned that a piece of draft ESMA guidance, with such far-reaching and significant (potential) implications, was published subsequent to the first date on which firms were able to notify Competent Authorities of their market making/primary dealing exemption and only a month and a half before the entry into force of the actual Regulation (1 November 2012).

We understand that the deadline for entry into force is outside ESMA's control and appreciate the Authority's considerable workload. However, there must be an appreciation from policy makers and supervisors that recent developments with regard to the market making/primary dealing exemption have created challenges in terms of implementation, and undoubtedly increased their compliance risk. An appropriate lead time is essential because the definition may have a fundamental impact on: the structure of the market; firms' ability to respond to client requests; and IT systems that may need to be re-designed.

5. Are there areas of EU financial services where the difference between forms of regulation (non-binding Code of Conduct or Recommendation to Member States vs legislative proposals) has affected your activities?

Yes. As per our response to question 2, we refer to the area of post trading services and the example of the industry Code of Conduct on Clearing and Settlement (2006), at the time supported by EU authorities, which has not delivered the non-discriminatory access to infrastructures required to achieve competition. This is a clear example where voluntary arrangements are allowing vested interests and an unlevel playing field to prevail at the expense
of market integration and efficiency.
To increase competition in post trade services in response to the 2001 Giovannini Report, the industry signed the 2006 Code of Conduct on Clearing and Settlement. Progress was made in price transparency and service unbundling, but the Code failed to deliver the access between infrastructures required for competition. While the concerns regarding regulation have now been addressed by regulators in their examination of interoperability and by the EMIR legislation, the vested interests in the current uncompetitive environment can only be addressed through the legislation proposed by the Commission in its MiFID 2 / MiFIR proposals.

As explained under question 2 above, the current MiFID 2 / MiFIR debate is an opportunity to address this long standing inefficiency in the single market.

6. How do you think the coherence of EU financial services legislation could be further improved?
Please comment in particular on the extent to which the following would help to improve the coherence of future EU financial services legislation (please give examples to support your answer where possible):

a) a framework for legislative reviews or review clauses included in initial pieces of legislation which link to the reviews of other related legislation?
b) a unified, legally binding code of financial services law?
c) different arrangements within the EU institutions for the handling of legislative proposals (please specify)?
d) other suggestions?

AFME considers that a more rigorous process for developing financial services legislation is of outmost importance. We would support measures that enhance and strengthen:

- the development of cross-regulation impact assessments both per individual market segment, product and/or evaluating the cumulative effects of the main directives on markets, economies, economic agents; in this context, we would particularly welcome cross-regulation impact analyses on the following topics:
  - securitisation
  - bank funding (regulations impacting on covered bonds, securitizations, unsecured debt, deposits etc)
  - risk mitigation and hedging
  - product innovation
  - market making
  - trade finance
- the articulation of concrete legislative objectives;
- the comprehensive assessment of the themes of this consultation: coherence of legislation, consistency of regulation and whether the objectives have been addressed elsewhere;
- the application of the principles of subsidiarity and proportionality; and
- the consultation process with stakeholders.

We provide below feedback on the points raised in this question.

a) We support robust review processes and an enhancement of the mechanisms for assessing the impact of legislation. Linking pieces of legislation and their reviews would be
appropriate and enhance coherence when referring to *complementary* legislative acts serving different purposes (such as MiFID and EMIR), rather than *duplicative* regulations addressing the same issues with different outcomes (see our comments under questions 1 and 2).

b) The building of a more integrated body of law is likely to be an ambitious exercise, but we believe it would lead to more clarity and consistency in the design, implementation and monitoring of legislation. We would support this exercise as a long term workstream, but consider that the priority should be the appropriate implementation of current reforms.

c) We refer to our comments under question 7 on supporting the independent nature of the ESAs and their decision making to meet their obligation to analyse the potential related costs and benefits of proposals and for stakeholders to assist in this analysis in the most appropriate manner. In relation to impact assessments (see point d below), the European Parliament and Council should regularly consider commissioning independent analysis of the costs and benefits of proposals and not rely solely on the analysis provided by the Commission.

d) We believe that the most important factor in improving the coherence of legislation is the quality of the impact assessments that should accompany all proposals, including those tabled during the Council and Parliament readings (i.e. those that may not have been included in the Commission’s original proposals). We refer to examples such as the proposals on remuneration adopted in the CRD IV legislation and proposals to remove or narrow the use of transparency waivers in equities in the MiFID 2 / MiFIR debate. In these examples the specific proposals were not clearly set out in the Commission’s original proposals and therefore did not benefit from full impact assessment. Rigorous, comprehensive and independent data-based analysis of costs and benefits to market participants and the wider economy is fundamental to ensuring coherence and an appropriate implementation of policy objectives. We believe impact assessments should also assess the cost implications to end users as well as to the financial services industry. Please also refer to our comments under question 9 on the cumulative impact of legislation.

7. What practical steps could be taken to better ensure coherence between delegated acts and technical standards and the underlying "Level 1" text?

With a very significant body of Level 1 legislation in the process of being completed, the next EU legislative cycle is likely to place emphasis on the appropriate implementation of the legislation and the production of high quality technical standards and implementing acts. Consistency with the objectives and spirit of the response to the financial crisis and needs of the European economy should be key guiding principles.

We can suggest the following steps to better ensure coherence between delegated acts and technical standards and the underlying Level 1 text:

- There needs to be a structured timetable and realistic phasing set out at Level 1 for the development of implementing measures to allow the ESAs to undertake appropriate consultation and evaluation processes. Rushed implementation processes can lead to insufficient consideration and therefore sub-optimal outcomes. The implementation
timelines enshrined in the Level 1 texts need to reflect these challenges.

- As noted under question 4, it is critical that the ESAs are able to meet their obligation to analyse the potential related costs and benefits of proposals and for stakeholders to assist in this analysis in the most appropriate manner. We are strong supporters of the independent nature of the ESAs in fulfilling their mission.

- It would be helpful to ensure there is a transparent and comprehensive dialogue between authorities and market participants in relation to the interpretation of Level 1 texts. In the example of the implementation of the Short Selling Regulation (see question 4), AFME and ISDA presented detailed, independent legal analysis of the Level 1 text, but we did not have the possibility to consider the legal analysis provided by the Commission to ESMA underpinning the interpretation of the Regulation adopted in the ESMA Guidelines.

8. Which area or specific change would you identify as the highest priority for the 2014-2019 mandate in terms of improving the coherence of EU legislation?

We believe that there should be a number of priorities for the 2014-2019 mandate. Amongst these are the following.

- Conduct a comprehensive analysis of the impact and effects of the reforms proposed and adopted under the previous mandate. This analysis would enable policymakers and stakeholders to take stock of the cumulative impact of legislation and understand the added value of further legislation before proceeding with its adoption. Such a cumulative impact, followed by careful assessment of reforms would represent the most important step in improving the coherence of legislation.

- Ensure that the prudential reforms to stabilise the European financial system – CRD IV, Banking Union and Bank Recovery and Resolution – are appropriately implemented.

- Implementing policies that contribute to addressing the long term financing needs of European governments, businesses and citizens. The focus of the 2009-2014 has rightly been on stabilising the financial system. The next mandate, while continuing to serve the objective of financial stability, should give greater attention to policies considered in the Commission’s Green Paper *Long Term Financing of the European Economy*. AFME fully supports the objectives of the Green Paper to initiate a broad debate about how to foster the supply of long term financing and how to improve and diversify the system of financial intermediation for long term investment in Europe.

9. Do you consider that the EU legislative process allows the active participation of all stakeholders in relation to financial services legislation? What, if any, suggestions do you have for how stakeholder participation could be enhanced?

Notwithstanding the issues identified in other sections of this response, we believe the EU legislative process generally provides opportunities for stakeholder engagement.

It is important that interested parties from the full range of perspectives are able to engage well with the legislative and regulatory processes. Optimal outcomes are achieved if legislators and regulators are well-informed by the full range of insights and perspectives including those of consumers and users of financial services, actors in the wider economy, as well as financial
markets participants. We welcome advances that have been made in this regard.

10. Do you consider that EU legislators give the same degree of consideration to all business models in the EU financial sector? Please explain your answer and state any suggestions you have for ensuring appropriate consideration of different business models in the development of EU financial services legislation.

We appreciate that the financial crisis and tax payer funded bailouts have rightly resulted in an examination of risk-taking behaviours and business models in the financial sector. It is appropriate that policymakers carefully examine and address through regulation any practices that can exacerbate systemic risk. It is equally important that regulations are proportionate to the risks involved and avoid a punitive effect on responsible risk-taking and socially beneficial practices.

In the context of this consultation, it is worth commenting on the greater emphasis that is being given in current debates to long term financing. AFME is fully supportive of this and welcomes the aims of the Commission’s Green Paper *Long Term Financing of the European Economy*. Whilst it is important to examine ways to bolster the channelling of resources towards long-lived capital and to incentivise long term behaviours, we are cautious about the creation of a potential trade-off between such behaviours and the important continuing need for strongly functioning mechanisms of maturity transformation in the form of secondary markets trading strategies. Long term behaviours require the operation of strongly effective mechanisms of maturity transformation capable of transforming the varying time horizons of investors into long term funding for the economy as a whole. This should include all types of finance that can accommodate different investor and corporate needs. It is unhelpful to take a narrow and mutually-exclusive view of what constitutes long and short term funding and behaviours.

We have observed cases of potential negative perception and undue regulatory treatment towards trading models that are sometimes wrongly labelled as shortermist and based on speculation. We believe that a number of market activities beneficial to the economy and the intermediation chain are being caught under this perception. We refer to the examples below.

**Structural reform of the banking sector in the context of the Liikanen report and its follow-up**

Should EU legislators pursue proposals to mandatorily require banks to segregate their large-scale trading activities from other banking business, it could be argued that a particular business model is being imposed despite HLEG acknowledgment that no one business model was responsible for the crisis. We recommend that authorities study carefully the empirical evidence regarding the benefits/risks of diversification in the banking sector and the strengths/weaknesses of different business models. Please also see our comments under question 1.

**Market making and intermediation-based models**

We are concerned by what appears to be an emerging negative perception in certain quarters towards trading models based on market making and intermediation. An expression of our concerns can be read in the Commission’s impact assessment in relation to the proposed Financial Transactions Tax. This appears to cast doubt on the benefits of intermediation via market making activities.
A significant number of rules have been proposed, agreed or implemented over the past 2-3 years with the effect of restricting the activities of intermediaries in the securities markets. The cumulative application of these rules will significantly reduce, and, in certain cases, freeze liquidity provision in those markets. By way of example:

- The Financial Transactions Tax: The FTT proposal does not recognise the importance of intermediation in its design. The “gross basis” application of the FTT will lead to a “cascade effect” which massively increases the impact of the tax. By contrast, most taxes operate on a net basis (e.g. VAT, corporation and income). Taxing on a gross basis creates the potential for multiple layers of tax in a chain of transactions. For example the sale and purchase of equity within the FTT zone would be charged at multiple stages of the chain of settlement. Another form of intermediation, client facilitation, is essential to a proper functioning of European bond markets. It is challenging to match buyers and sellers in these intermittent markets, particularly at the same price and size. Trading in these markets would also be hit with multiple layers of taxation. The chain of intermediation is a common feature of all financial markets. The proposed FTT will not eliminate this intermediation - but it will tax and thereby introduce significant economic constraints on intermediaries, resulting in additional costs for the investors wishing to buy and sell and the issuers wishing to raise finance.

- The MiFID 2 / MiFIR debate: We are concerned by proposals that seek to impose one-size-fits-all models for the trading of instruments, resulting in instruments having to trade on venues that are not currently designed to accommodate all trading features and diverse investor needs. See our comments under question 1.

We stress that the EU is currently reviewing legislation that already provides national Competent Authorities and ESMA with effective tools, including criminal sanctions, to deal with situations of market abuse, conflict of interests and other rent seeking behaviours. These are the Market Abuse Regulation and Directive.

The above developments are at odds with what has been noted by the Commission in the context of the publication of the Green Paper on long term financing: “providing liquidity is an important function of secondary markets. Liquid and well-functioning secondary markets encourage investments in primary markets too, as this enables investors to sell their investments quickly and at low costs when needed.” Market making and the role played by intermediaries in capital markets are critical in this regard and should not be penalised.

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**Note on answering the questions**

Please clarify in your answers whether your example relates to financial services legislation in force, or to proposals still under consideration. For example, if you refer to MiFID as an example, please specify whether your point relates to Directive 2004/39/EC (“MiFID 1”) and accompanying legislation.

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http://www.cliffordchance.com/publicationviews/publications/2013/02/the_european_commissionsfinancialtransaction.html
implementing measures, or to the MiFID 2 negotiations based on Commission proposals COM (2011) 652 and 656.