



March 2011
AK Position Paper

Consultation of the European Commission concerning the revision of the Financial Instruments Directive (MiFID Directive)

About us

The Federal Chamber of Labour is by law representing the interests of about 3.2 million employees and consumers in Austria. It acts for the interests of its members in fields of social-, educational-, economical-, and consumer issues both on the national and on the EU-level in Brussels. Furthermore the Austrian Federal Chamber of Labour is a part of the Austrian social partnership.

The AK EUROPA office in Brussels was established in 1991 to bring forward the interests of all its members directly vis-à-vis the European Institutions.

Organisation and Tasks of the Austrian Federal Chamber of Labour

The Austrian Federal Chamber of Labour is the umbrella organisation of the nine regional Chambers of Labour in Austria, which have together the statutory mandate to represent the interests of their members.

The Chambers of Labour provide their members a broad range of services, including for instance advice on matters of labour law, consumer rights, social insurance and educational matters.

Herbert Tumpel
President

More than three quarters of the 2 million member-consultations carried out each year concern labour-, social insurance- and insolvency law. Furthermore the Austrian Federal Chamber of Labour makes use of its vested right to state its opinion in the legislation process of the European Union and in Austria in order to shape the interests of the employees and consumers towards the legislator.

All Austrian employees are subject to compulsory membership. The member fee is determined by law and is amounting to 0.5% of the members' gross wages or salaries (up to the social security payroll tax cap maximum). 560.000 - amongst others unemployed, persons on maternity (paternity) leave, community- and military service - of the 3.2 million members are exempt from subscription payment, but are entitled to all services provided by the Austrian Federal Chambers of Labour.

Werner Muhm
Director

Executive Summary

The European Commission has initiated a Consultation on the MiFID at the beginning of the year. It plans to present a bill for June 2011. The Commission intends to implement the following concerns:

the elimination of unfair competition and the discrimination of the various market places, the protection of small investors and the regulation of commodity exchanges.

The AK position in detail

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The AK welcomes the proposal of the Commission to critically reconsider and to completely overhaul the MiFID Directive. There is no doubt that the creation of new alternative trading platforms in conjunction with many other unregulated financial markets and platforms is developing into an undesirable direction. The financial crisis has clearly shown that the confidence that the Commission continued to place in the efficiency of markets and their self-regulation has been misguided. The belief in the paradigm that free, i.e. unregulated markets automatically produce all necessary information on fundamental data in a rational manner, thereby guaranteeing balanced prices, has proved illusory. In reality, irrational expectations, "animal spirits" and the objective of increasing one's own market power play a central role in the decision-taking process of market participants. Finally, too much confidence was put into the manageability of risks by using mathematical risk models, which at the end of the day are only founded on assumptions based on historical data, which is projected into the future.

The financial crisis has not only unsettled the financial markets and put the real economy and the national budgets under pressure, but it has also fundamentally put many assumptions of the contemporary view of the economy into question. That is why the AK is not able to endorse the introductory arguments of the Commission on the Consultation, which continue to advocate the benefits of deregulation and more competition.

1.) Competition of the market places

Damaging arbitrage

In contrast to the expectations of the Commission, the opportunity to open new market places did not result in more efficiency through competition, but in an undesirable non-transparency concerning market players, traded products, trading activities, mutual trade relations and not least pricing. Apart from that, regulatory arbitrage was on the increase because little to not at all regulated market places were preferred over regulated stock exchanges without making sure that sufficient controls in respect of price manipulations were in place.

It is also a very idealistic view that competition automatically results in cost efficiency and innovation. The impact assessment, which accompanies the proposal for a EU regulation on OTC derivatives, central counterparties and trade repositories [COM 2010(484)] states under point 68: "In contrast to the competition between CCPs, which is based on technological innovation, competition based on the reduction of standards, hence competition based on risk is highly undesirable as it may have a serious negative effect due to the systemic role of CCPs." This argument is highly relevant in connection with the MiFID, not only concerning the regulation von CCPs, but also of all other trading places.

In order to avoid any further fragmentation of the market, AK is very critical of the creation of an additional category of trading platforms

The new variety of trading places caused the creation of a new type of “arbitrage traders”, which benefit from minimum price differences at various trading places through computer programs running at top speed. According to estimates of the sector, the high frequency trade, HTF) amounts to 60-70 % by now. This is added to the fact that it cannot be excluded that some algorithms of this high frequency trade are fraudulent and aimed at taking advantage of other investors.

In order to avoid any further fragmentation of the market, the BAK is very critical of the creation of an additional category of trading platforms, namely organised trading facilities. The AK certainly recognises the intention of the Commission to also include the little transparent and regulated part of the financial market. However, there is the danger that trade, which until now has taken place via multilateral trading platforms, migrates to these, which would ultimately result in inflating trade even further.

Instead of constantly adapting the regulation scope to the latest practices and structures of the sector, it would be better to lay down restrictions for the development of trading practices and structures of the sector within the meaning of a market regulation. This includes in concrete terms that financial products have to be structured in such a way that they can be traded via organised trading places and cleared via central clearinghouses. If this is not the case, it should be considered to

ban them. That is why the BAK is in favour of adjusting the rules for multilateral trading platforms to those, which apply to stock markets and of limiting permitted financial products instead of admitting yet another “little-regulated” trading platform.

Insufficient protection of small investors

The often used argument of cost and price advantages has no relevance for private investors, in particular small investors, as in most cases they do not have access to trading platforms. Apart from that, brokers, traders and other financial institutions normally do not pass the advantage of lower transaction costs, which result from weak regulation standards and less regulated trading places on to private investors.

Furthermore, the revision of the Directive should be seen as an opportunity to learn the lessons from the numerous scandals in connection with selling complex financial derivatives to small investors and to impose appropriate strict regulations without exceptions.

This is why the MiFID should apply to all types of traders, including those that can be defined as small or medium-sized traders.

The MiFID should also take strict measures with regard to products: selling structured investments to small investors must therefore be banned. In view of the rapid development of the

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financial markets, a differentiation into complex and less complex products appears to be outdated and difficult to carry out.

Moreover, the distribution practice should also be looked at carefully: the principle of thorough initial consultation should therefore be given top priority and must be included in the Directive - without exception and independent of the type of transaction.

Finally, concerning law enforcement, asymmetric market information at the expense of small investors requires a reversal of the burden of proof. This will also create an additional incentive for financial institutions to improve their service and consultancy practices. This also includes the introduction of class action - which contributes to relieving the pressure on the courts - as well as the extension of the statute of limitation in respect of compensation claims.

Criterion of liquidity and market volume

Lastly, the much lauded increase in liquidity is highly questionable:

If it was generally assumed that greater liquidity would result in greater efficiency and therefore in more stability per se, the excessive liquidity in fragmented and non-transparent markets led to wrong pricing in both the pre-crisis scenario (characterised by decreasing risk premiums and desperate searching for higher interest rates with increasingly complex and exotic products) and the post-crisis scenario (characterised

by exorbitant risk premiums) through panic reactions and herd behaviour.

The experience of the crisis shows that excessive liquidity can quickly turn into a lack of liquidity, which brought the financial markets almost to their knees. Only the massive interventions of the central banks and governments were able to keep the markets alive and to prevent assets from melting away, caused by little sustainable liquidity and the non-transparency of instruments, trading places and corporations (e.g. AIG).

The market itself was bloated to an enormous volume, especially in the less regulated sector. According to the three-year report of the Bank for International Settlements from 2010, there was extreme growth of OTC derivatives compared to 2007. In spite of the fall caused by the crisis, OTC positions in the derivative market increased in the three following years. At the end of June 2010, the fictitious receivables reached a value of 583 trillion USD, 15 % higher than the value recorded in 2007. The immense increase is combined with high interconnection, complexity and market concentration. Hence, it has not been possible to achieve financial market stability up to now. This in turn has had a serious impact on the economy as a whole, in particular for workers.

The AK is therefore urging for reducing trade and for cutting the volume of those financial products, whose transactions are taking place outside of stock exchanges and multilateral trading platforms and which (usually because of the inadequate standardisation de-

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gree) are rated as non-qualifying for central clearing. It must be avoided under all circumstances that the improved transparency requirements and possibly very elaborate regulatory provisions only cover a (small) part of the entire financial transactions (for example only shares), whilst the major part of transactions (such as OTC derivatives) remains "in the dark".

2.) Regulation of commodity exchanges

Finally, the AK supports all proposals, which concern a regulation of the commodity markets. As the crisis led to a strong mistrust towards the financial markets, the financial institutions highly recommend investing into commodities.

Therefore, the regulation of this market is high on the EU's list of priorities as both private households and consumers are massively affected by unforeseeable price fluctuations concerning commodities such as oil, electricity, cereals, etc., which are caused by speculations. This problem is not unknown to the supervisory authorities, as commodity futures have already been bought and sold since the start of the 20th century by speculators, who had no interest in the production, processing and the distribution of food. This activity began to influence the current price development for food and commodities on the daily spot market, which made it increasingly volatile. Following the Wall Street Crash, the Roosevelt Administration in the USA already recognised this problem and introduced position

limits to prevent excessive speculation. Unfortunately, this regulation was reversed again at the start of the 21st century by exempting a large number of commodity traders from the trade limits of the 1930ies. At the same time, derivative contracts referring to food and commodities saw a large increase.

Therefore, from the AK's point of view a first important step should be to categorise traders, to subsequently introduce position limits and to reduce or exclude OTC trade. In addition to this it is necessary to introduce a suitable and transparent reporting system under public control for all transactions to ensure transparency and to be able to nip market manipulations in the bud. Reliable market data on open net positions are vital for the stability of the financial and in particular the commodity markets.

3.) Summary and need for action

Ultimately, the AK would like to point out that the MiFID as it stands does provide no added value at all in relation to sustainable liquidity and the creation of new jobs and only very little added value for the protection of investors. The paradigm of self-regulation for large parts of the financial markets and instruments has not only failed, but it has resulted in high costs - debt of the Member States, unemployment and cuts in the social systems. The AK also emphasises that individual interests of both financial and non-financial companies may be entirely legitimate; however, the public good of financial market stability and the adequate fulfil-

ment of the refinancing function by the financial sector have to be the overriding aim of any regulation. Unfortunately, these two requirements of stability and the refinancing function, which also top the list of priorities from the workers' point of view are too often hardly ever mentioned in the debate. The BAK is therefore in favour of the public interest taking absolute priority over microeconomic concerns.

- Standardisation of the requirements for establishing alternative trading platforms at the same level as security and commodity exchanges,
- Supervision of the alternative trading platforms in the same way as security and commodity exchanges, i.e. public supervisory authority,
- Standardisation of all financial products, independent of on which trading place they are traded, with the consequence that non-standardised products are not tradable and as a result not enforceable,
- Development of a financial market seal of approval,
- Introduction of class action, the reversal of the burden of proof as well as the extension of the statute of limitation in respect of compensation claims in favour of small investors,
- Exclusion of traders, who do not act physically on commodity exchanges, introduction of position limits and limitation of the quantity of derivatives which may be traded on a specific market.

Should you have any further questions
please do not hesitate to contact

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