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THE MARKET REFORM WATCH BULLETIN

Regulations: The Return Of The Living Cerberus

The development of the new **Markets in Financial Instruments Directive (MiFID II)** has been commenced by the European Commission in order to bring the existing regulations up to date and introduce new aspects of financial market functionality. The proposals published in October 2011 will fundamentally impact the markets in terms of the wide product range, as well as policy areas, including equities, derivatives, fixed income, compliance and the internal procedures. The proposed reforms deal with the following key areas:

- Development and changes in market structure (including OTC space);
- Authorization and organizational requirements;
- Supervisors;
- Transparency;
- Investment protection and provision of investment services.

Time Frame: The final text of MiFID II should be published in 4Q2013 (has to be discussed and adopted by the EU Commission, Parliament and Council). MiFID II is planned to come into force in 2015.

Main Objectives: More transparency, less risk, integration of the EU financial markets, control over the OTC market.

While the lawmakers are preoccupied with developing the next fully loaded testament, we are keen on guessing how it may influence our daily business in the not so distant future.

Likely Implications:

- The market structure changes (impact on voice trading; market marking; OTC trading)
    - OTC instruments have to be exchange traded or traded with the use of electronic platform (migration from voice to electronic trading).
    - OTF (Organized Trading Facility) implementation — OTC markets have to be in compliance with exchange regulations.
- Pre-trade transparency (mostly affecting Market-Makers)
    - Force all quotes to be firm.
    - Disclose all quotes upon client's request.
    - Enlarge dissemination of quotes by providing the equal access to all clients.
    - Bring together buying and selling interests or orders.
- Post-trade transparency
    - Implementation of OTF entails setup of data management reporting systems similar to the ones used by the exchanges.
    - Enforce publishing of post trade information with live updating.
- Regulations
    - The EU Commission will enforce non-EU firms operating in EU space to act in compliance with the MiFID regulations.

Potential consequences and our current view: In the survey by Association for Financial Markets in Europe (AFME) 56% of market participants believe MiFID II introduction would have a strongly negative impact on the market. The profound change will affect the securities issuers and their implied costs too. Market makers would be forced to run higher transaction costs, apply further restrictions to their client base, or give the client business up to avoid contingent risks (recall how the U.S. domiciled private money has been drifting away from the European shores lately). The reforms, if implemented in the presently proposed shape, will lead to widening of the bid/offer spreads, decrease of trading activity (i.e., in trading volumes, transaction size) and an overall increase in the trade-related costs), and they will have an "unintended" damaging effect on the overall market liquidity, especially in the less liquid instruments.

Taxation: Heads Or Tails of the FTT implementation

The Financial Transaction Tax (FTT) was proposed by the EU Commission in 2011 with the main objective to increase tax revenues of the member countries budgets, with the consequent behavioral change to damp speculative trading. Two years into the painful debates, the FTT substance and the final implementation shape is still unknown. The originally proposed taxes at the rates of 0,1% for bonds, 0,1% for equities, 0,01% for derivatives were to be imposed on all transactions on financial instruments between financial institutions when at least one party to the transaction is located in the EU. Initially it was also planned that the FTT would cover all transactions that include EU companies, whether these transactions occur within the EU or elsewhere in the world.

The tax, despite its justified purpose, pronounced in the midst of the global financial turmoil, clearly had a strong political flavor in it, which fueled the hasted enforcement of the similar taxes in France and Italy without waiting when the Commission would finalize discussing the matter with the other 9 participating countries. It has soon become clear that the FTT turned into yet another example of a badly weighed and inefficient solution. See it for yourself:

REAL LIFE EXPERIENCE:

France:

The French FTT was enforced on August 1, 2012 for the following transactions:
• French equities;
• High frequency-trading transactions in equities;
• Uncovered CDS in the EU sovereign debts.

The FFTT tax rates are:
• 0.2% on purchasing transactions in French equity trades;
• 0.01% on high-frequency trading;
• 0.01% on uncovered CDS.

The FFTT is applied regardless of where the transaction is entered into and the tax residence of the parties.

The following consequences have materialized after the introduction of the FFTT:
• Tax revenues are 600 mln (1.6 bln expected);
• Decline in trading volumes in terms of stocks (from 10 to 15%).

Italy:

IFTT is imposed on certain financial transactions made as from March 1, 2013 and from July 1, 2013.

According to the latest data the taxation of equities transactions has been postponed from July to 16 October 2013 and the tax on derivatives until September 1, 2013.

The IFTT is imposed partially involving the following:
• Shares and other participating securities issued by Italian resident companies.
• Derivative contracts.

The tax rates are:
0.22% (for 2013 only) and 0.2% (as of 2014) for OTC transactions
0.12% (for 2013 only) and 0.1% (as of 2014) for trades executed on a regulated market or multilateral trading system.

The taxes are imposed regardless of where the transaction is entered into and the tax residence of the parties.

Because of the constant delays of the tax implementation, there is a lack of data on taxed trading volumes and the impact of this tax.

As for the 2nd of July 2013, the FTT delayed till the mid of 2014.

Transactions in equities shall be subject to the tax initially, while bonds and derivatives will be taxed after 2 years of the tax implementation.

The EU Officials do not agree on the exact tax rates for each transaction. The experience of the local implementation of taxes on financial transactions leads to the market contraction as investors tend to become much more reluctant to either reallocate, or make new investments. The spread of the FTT also should be revised due to the fact that the tax could be non-compliant with the international law. For now, the examined data suggests with a high final stage in its original version.