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SPECIALISTS IN SECURITIES AND FINANCE

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CALL FOR EVIDENCE

EUROPEAN COMMISSION – Internal Market and Services DG
Pre- and post-trade transparency provisions of the Markets in Financial Instruments Directive (MiFID) in relation to transactions in classes of financial instruments other than shares

Response from the French Association of Investment Firms (AFEI)

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INTRODUCTION

The French Association of Investment Firms (AFEI) represents investment service providers active in France. Its members comprise more than 120 investment firms and credit institutions authorised to provide investment services. Approximately one-third of AFEI members are subsidiaries or branches of foreign institutions.

The Association is contributing to all major public policy discussions impacting its members, at national, European or international level. MiFID has been our primary focus of attention for a number of years now. We are currently involved in the discussions concerning the transposition of the European legislation in France and busy helping our member firms getting ready for the implementation deadline. We are grateful for the opportunity to express here the views of our members and to contribute to the reflections of the Commission on this crucial matter.

This call for evidence investigates markets which are largely integrated at the European level. There appears to be collective scepticism and concerns regarding the application of extended mandatory transparency to non-equity markets. We have worked in close cooperation with other trade associations in Europe, and especially in London, and support much of the comments made in their answers to the present consultation.

SUMMARY

- We welcome the **sensible approach** developed by the Commission in this call for evidence. Overall, we agree with the scope, classification, background information and objectives proposed in the paper. However, we urge the Commission to consider the **concerns** expressed in our answer.

- While AFEI has always advocated the importance of transparency in equity markets, the Association believes that the structure and organisation of the non-equity markets are fundamentally different from that of the equity market and that the matter of transparency raises different questions.

- European bond markets have grown rapidly and **efficiently**, with low spreads, innovation and fierce competition. There is no clear evidence of market failure. Any changes in the regulatory framework, particularly relating to transparency obligations, must be considered very carefully.

- The regulation of markets should not focus only on the issue of price transparency, but should consider the **wider set of rules** applying to markets and market participants and which all contribute to the integrity, efficiency and overall transparency of the markets. MiFID will notably introduce enhanced investor protection provisions which have not come into effect yet.

- We have strong misgivings about the **potential impacts** of any mandatory transparency and its **actual benefits**. In terms of *pre-trade* transparency, imposing greater transparency could be seriously disruptive, without clear expected benefits. In terms of *post-trade* transparency, we have serious concerns regarding a broader dissemination of information. It could actually negatively affect the efficiency of the market because it could reduce the capacity and willingness of dealers to put their capital at risk and take on investor positions, in particular in large trade size and for illiquid issues. It could undermine the business model of many intermediaries which would be forced to exit the market or to reduce the services they provide. Investors could eventually end up in a worse position with no liquidity being provided to them where they need it the most and reduced services.

- Therefore, we favour the **no-change** option for all the different instruments under the Commission's review. We are willing to consider **limited** forms of extension of post-trade transparency arrangements, on the basis that clear benefits are identified and that the proposed changes do not have adverse impacts on **market efficiency, liquidity and competition**. In all cases, extreme caution will be required. Because the markets work efficiently, and evolve constantly to reflect clients' preferences and needs, changes should be left to **market forces**, and if needed, self-regulation.

DETAILED ANSWERS

Question 1: Do you have any comment on the proposed scope of the Report?

We agree with the scope of the Report proposed by the Commission.

MiFID has introduced an innovative, complex and somehow challenging new transparency regime for equity markets, based on the history and characteristics of the European equity markets at the time of the revision of the ISD. The impact of the new rules is also yet to be seen and assessed. We agree with the Commission that a **range of options** should be considered, including no regulatory intervention. We also welcome the distinction made by the Commission between pre- and post-trade transparency. The matter of transparency indeed raises different and complex questions for the different markets considered. Regulation cannot be envisaged identically since the impact of similar arrangements (notably related to transparency) will have far different consequences according to the types of instruments considered and the organisation of the related markets.

Question 2: Do you consider this classification scheme to be sufficient for the purposes of the review?

Although different classifications might be considered, we believe that the classification suggested by the Commission is sufficient for the purposes of the review, subject to appropriate prioritisation as discussed in Question 4 of the consultation paper.

Question 3: Do you consider there are possible policy rationales for mandatory transparency we have not listed?

The Commission lists three possible policy rationales to justify mandatory transparency: investor protection, market efficiency and technological developments.

First, whilst we appreciate that the mandate of the Commission focuses on price transparency obligations, we would like to stress that the issue of transparency should not be considered in isolation of the **wider set of rules** applying to non-equity markets and their participants, and which all contribute to the integrity, efficiency and overall transparency of the markets. Thus, mandatory price transparency is not necessarily the only or most appropriate way to look for greater investor protection and market efficiency, if needed. In addition, we point out that MiFID enhanced investor protection regime (including information to clients, suitability assessment, management and disclosure of conflicts of interest, and best execution obligations) have not come into effect yet. The impact of those new provisions will have to be assessed.

Second, while technological developments might facilitate some forms of mandatory transparency, they do not justify it.

Overall, we believe that there would be a policy rationale to impose greater transparency if and only if: (1) there are **proven market failures** in terms of investor protection and market efficiency; (2) *mandatory* price transparency is seen as the **best option** to address those market failures; and (3) the **benefits** of any regulatory intervention clearly outweigh the related costs and potential adverse effects. We welcome the Commission's reference to the global better regulation agenda as well as the suggested process for problem identification detailed in section 4.1 of the Commission's paper.

Question 4: Do you agree with our proposals for prioritisation of the review?

We welcome the sensitive approach of the Commission which proposes to set priorities for its review of non-equity markets.

However, the Commission notes that efforts *"should be focused more on those markets where potential investor protection concerns are more prominent".* We believe that the Commission should keep **both objectives of market efficiency and investor protection** in mind when considering the appropriate level of transparency in markets. In addition, reflections must clearly take into account the necessary distinction between the **wholesale and retail** segments, and whether there is direct or indirect retail participation. A tailored and proportionate approach is necessary to address specific regulatory concerns related to the retail segment (see also below Question 5). Finally, as mentioned above, price transparency is not necessarily the most effective means to ensure greater investor protection. Other rules, including the ones

established by MiFID or other Directives like MAD, significantly increase the level of obligations of intermediaries and will strengthen investor protection.

Question 5: To what extent do you consider there to be:
a. observable or demonstrable problems with respect to the possible policy rationales for mandatory transparency identified above in relation to one or more of the instrument markets under review?
b. evidence that mandatory pre- or post-trade transparency would solve any of those problems?

There is **no clear evidence of substantial market failures** in the instrument markets under review. While some instrument markets might still lack empirical and/or theoretical background to support our assessment, the two recent CEPR studies published, as well as the FSA Feedback Statement recently released, conclude that European bond markets appear to be work efficiently.[1] The FSA notes: *"We do not see any evidence of substantial market failures related to transparency in wholesale bond markets based in the UK"*. For government bonds, Portes and al. (2006) show that the market has produced the level of transparency where it is possible (e.g. on electronic platforms) and maintains more opaque market segments where needed (e.g. for large trades). For corporate bonds, Biais and al. (2006) show that the European corporate euro-denominated bond markets exhibit lower effective spreads than the US market, including after the introduction of TRACE. According to the authors, and we share this analysis, there is a high degree of competition in the European bond markets to supply liquidity. It is competition which, to a large extent, determines the spreads in the market.

Those papers highlight the complex relationship in the bond markets between transparency and efficiency – and the link with liquidity. Not only higher transparency does not necessarily translate into increased liquidity, but an excess of transparency may have detrimental effects on the provision of liquidity, thus reducing the overall efficiency and quality of the market.

In terms of *pre-trade* transparency, there is already price information available, both with the development of pricing sources and electronic platforms (see Question 6 below) and because clients request prices from different intermediaries before trading and compare those prices. As the CEPR and FSA reports show, we believe that imposing greater transparency would be very difficult and costly to implement, and more importantly, could be very **disruptive**, without clear expected benefits for market participants.

In terms of *post-trade* transparency, we also have serious concerns regarding a broader dissemination of information. It could actually negatively affect the efficiency of the market because it could reduce the capacity and willingness of dealers to trade illiquid issues. It could undermine the business model of many intermediaries which would be forced to exit the market or to reduce the services they provide. Investors could eventually end up in a worse position because of lower level of competition, market shrinkage and reduced services.

Some argue (notably Biais and al. (2006)) that some ***limited*** forms of post-trade transparency in the corporate bond markets could improve information dissemination and foster competition. Overall, we have strong misgivings about the actual benefits of any mandatory post-trade transparency and the potential

[1] P. Dunne, M. Moore, R. Portes, *European Government Bond Markets: Transparency, Liquidity, Efficiency*, CEPR, May 2006; B. Biais, F. Declerck, J. Dow, R. Portes, E.-L. von Thadden, *European Corporate Bond Markets: Transparency, Liquidity, Efficiency*, CEPR, May 2006; Financial Services Authority, *Trading Transparency in the UK Secondary Bond Markets*, *Feedback on DP05/5*, July 2006.

detrimental impacts in terms of liquidity and level of competition in the market. It should also be noted that, for confidentiality reasons and to ensure a good execution of big size orders, many clients do not want to see their prices and trades posted. In addition, for the majority of bonds that do not trade often, the last traded price can be irrelevant or misleading. **Extreme caution** is therefore requested in terms of the *types of bonds* covered, proposed *delays* and the *extent of information* to be made available to the market.

The Commission also lists in section 3.3 other possible policy rationales for mandating greater transparency, namely (i) best execution purposes, (ii) valuation and (iii) retail participation.

(i) Best execution is first and foremost a conduct of business issue rather than a price transparency issue. It does not equate to best price, which is itself a function of a wide set of factors. Again, there is no central market providing a reference price for the markets under review. Investors compare different prices – a consideration that is fundamental to the markets. Different dealers may be able to deliver better execution outcomes than others.

(ii) Valuation services are provided by intermediaries to their customers. Other evaluation tools are also developing. There may be room for more evaluated pricing and benchmarks, but means for collecting the information, analysing and distributing would need to be carefully assessed. More importantly, market participants are continuously developing such tools and further developments should be left to market forces.

(iii) The corporate bond market remains indisputably institutional. There is no real sign of growth in retail participation in corporate bond market, at least in France. Although concerns about pensions may have a positive impact on bond holdings, it is likely that the bulk of it will be channelled through collective investment schemes.

As a matter of fact, the increase in direct participation of retail customers in the bond markets raises a series of questions going far beyond a pure price transparency issue, and which relate primarily to **marketing, investment advice, and investor education**. A 2005 NASD survey indicates that *US* individual investors know little about how bond markets work. For instance, only 40 percent understood that bond prices fall as interest rates rise. Retail participation will therefore, and probably should, depend first and foremost on appropriate marketing and advice from financial intermediaries. Those are extensively covered by the new provisions established by MiFID which will, together with the best execution regime, significantly strengthen investor protection.

We support FSA's statement that *"no case has been made for mandating greater transparency to address potential problems raised for retail investors in the UK. To the extent that additional transparency may be desired, we think an industry-led initiative to deliver targeted enhanced transparency would be a more effective solution than regulation".* We also refer to the recent French initiative aimed at increasing retail holdings of French government debt by implementing a secondary market for retail investors.

Question 6: To what extent could recent and upcoming technological and market developments in relation to the instrument markets under review:
a. contribute to a relatively inexpensive extension of mandatory transparency?
b. render mandatory transparency unnecessary?

As stated in Question 2, while technological developments might facilitate some forms of mandatory transparency, they do not justify it. The costs of extending mandatory transparency are not only those arising from the development of IT infrastructures allowing greater price dissemination. Costs should include the potential adverse effects on the markets, because of market shrinkage, distorted prices and consequent misallocation of capital.

As correctly described in the Commission's paper, pricing sources and electronic platforms have mushroomed for European bond markets over the last few years, with different characteristics and scopes. Those platforms have dramatically increased the level of transparency. An important comment to make is that these recent changes result from the combination of technological progress and market forces (including from the buy-side), but were not regulatory-mandated. Another important comment is that those developments evolve around the existing market structure and merely (though importantly) facilitate existing trading relationships between market participants. As such, and as highlighted in the CEPR research, voice trading remains the dominant form of trading in bond markets and plays a critical part in efficient price formation.

Question 7: To what extent are non-equity financial instruments different from equities so that lower levels of mandatory transparency in those markets may be justified?

Equity and bond markets differ on a number of aspects (central market *vs.* OTC market, rights and risks attached to the two types of securities and price determinants, frequency and size of trading, importance of the primary market and number of issues, remuneration of brokers-dealers, level of retail participation, links with the derivatives markets, role of inventories, etc.). As detailed above, the characteristics of fixed-income instruments and the organisation of the related markets justify different arrangements in terms of transparency.

Question 8: What data sources do you consider relevant to the issues you have raised (If appropriate, cross-refer to your answers below)?

We refer to the recent CEPR studies and the FSA feedback statement.

Question 9: Are there academic or institutional papers or ongoing work that should be considered in preparing the Report not included in our bibliography?

We consider the Commission's bibliography to be comprehensive. In the US, recent studies have shown the benefits of TRACE in terms of reduced spreads (although US spreads remain significantly higher than spreads in Europe, as shown in Biais and al. (2006)); however, regulators and market participants still lack today the necessary perspective to gauge the full consequences of the TRACE system. Greater analysis and research on the changes in market structure and the extent of benefits for investors are still needed.

Question 10: What conclusions do you draw from the existing academic debate and the work being conducted by other interested parties?

We welcome the new streams of research focusing on bond markets. We think that the results of the studies analysing the US and European markets partly diverge due to the significant differences between markets (see below Question 12).

We would also like to stress the lack of theoretical and empirical research available covering the other non-equities markets under review, including the high-yield corporate debt segment of the market which also exhibits specific characteristics compared to the investment grade segment.

Question 11: In your view, how applicable is the academic or institutional literature concerning transparency in the cash equities markets to the present discussion?

The academic or institutional literature concerning transparency in the cash equities markets is not applicable to the present discussion, because the market structures for each category of instrument are too different. While AFEI has always advocated the importance of transparency in equity markets, the Association believes that the structure of the different non-equity markets under review are fundamentally different from that of the equity market and that the matter of transparency, and its impact on price formation and liquidity, raises different and possibly more complex questions.

Question 12: What similarities, and what differences, are there between US and EU markets that should be borne in mind when seeking to draw inferences from the TRACE experience in the US?

The US and European corporate bond markets are fundamentally different, including in terms of history, size and liquidity, existing levels of competition, retail participation, existing levels of pre-trade transparency and spreads, as detailed in Biais and al. (2006) and in FSA (2006). As noted by the UK Financial Services Authority, *“The impact that TRACE has had on transaction costs for corporate bonds in the US is unlikely to be mirrored to the same extent in the UK or Europe”*.

Question 13: To the extent that you have identified problems or believe that others might do so, do you agree that only EU-level action would be appropriate in the present case?

The markets under review are highly integrated. Any analysis and prospect for change in the regulatory framework of those markets should take place at the European level. However, existing differences in domestic markets, notably in terms of retail investor participation, might have to be taken into consideration in order to ensure proportionate and focussed answers to specific concerns (see also Question 5 (iii) above).

Question 14: If you have identified problems or believe that others might do so, to what extent do you consider those problems would disappear as a natural product of market evolution in the short-to-medium term?

The markets under review change constantly, notably with the influence of the buy-side. The levels of transparency in particular have evolved, increasing where they could be supported by sufficient liquidity and facilitated by available technological developments. We expect further developments to occur in the years to come, which will seek to answer the different needs of market participants.

Question 15: In respect of both pre- and post-trade transparency, are the four options the right ones to consider **[no-change, option relying on self-regulation, a mandatory TRACE-like system, a mandatory MiFID-like system]*****, and in particular should other options be considered?***

Both the last two options suggested by the Commission (mandatory TRACE-like or MiFID-like systems) would represent a drastic change in the structure of the markets under review and could create serious disruptions in the functioning of those markets, resulting in lower efficiency. Because there is evidence showing that the markets are currently working well, and that an excess of transparency could result in decreased efficiency, more formal transparency will have to be very carefully handled and tailored to the specific needs of the markets.

Question 16: Would you, in light of your answers to the other questions, favour any of the four options in relation to pre- and post-trade transparency (or another option you might propose for consideration) in respect of transactions in any of cash government bonds, cash investment-grade corporate bonds, cash high-yield corporate bonds, asset-backed securities, credit default swaps, interest rate swaps and bond futures, or any other financial instrument you consider relevant?

Without clear evidence of failures in the functioning of the markets under review, we do not see scope for regulatory intervention of the European Commission. We again stress the potential detrimental impact of any significant regulatory-driven change in the transparency regime of the markets under review. We therefore favour the **no-change** option for the different instruments listed by the Commission.

However, we welcome the Commission's involvement in this important matter and its role in monitoring the various developments and changes in the markets. We are willing to consider possible limited forms of extension of post-trade transparency arrangements in the corporate bond markets, on the basis that clear benefits are identified and expressed by market participants, and that the changes implemented do not have adverse impacts on market efficiency, liquidity and competition.

In all cases, extreme caution will be required. Because the markets work efficiently and evolve constantly to reflect clients' preferences and needs, changes should be left to **market forces**, and, if needed, self-regulation.