

PRE- AND POST-TRADE TRANSPARENCY PROVISIONS OF MiFID IN RELATION TO TRANSACTIONS IN CLASSES OF FINANCIAL INSTRUMENTS OTHER THAN SHARES

CALL FOR EVIDENCE

GENERAL REMARKS

1. The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorised as banks and doing business in France, i.e. more than 500 commercial, cooperative and mutual banks. FBF member banks have more than 25,500 permanent branches in France. They employ 500,000 people in France and around the world, and service 48 million customers.

As universal banks, French credit institutions are directly and highly impacted by the enforcement of the MiFID on their main business lines: corporate and investment banking, intermediation, distribution.

2. In this context, the « call for evidence » published by the European Commission recalls that : « *The European Parliament and the Council have asked the Commission to report on the adequacy of the level of pre- and post-trade transparency in classes of financial instrument other than shares. The Report, required by Article 65(1) of the Markets in Financial Instruments Directive (MiFID), is due by 31 October 2007. The present document constitutes a call for evidence to be submitted to the European Commission services in relation to this report (the Report).*

The purpose of this call for evidence is to present, and seek feedback on, the Commission's preliminary orientation towards the Report in terms of the methodology and scope, the sources of data, and the other modalities of the Report. A list of questions is annexed to this call for evidence (Annex I). »

3. Indeed, the MiFID consecrated a high level of pre and post-trade transparency on the Equity markets (*both regulated markets and Multilateral trading facilities - MTFs*). The publication of the client order book and the reporting of transactions ensure the transparency on these markets.

Such a level of transparency seems natural on the Equity markets because of the combination of several factors.

First, the liquidity and price discovery process depend largely on the centralisation of the transactions (except for block trades), therefore on the dominant position of one trading venue for each stock. As a consequence, there is a need of information on an egalitarian basis for investors on listed stocks and on transactions.

Second, from Issuer's point of view, the transparency on Equity markets involves an easier knowledge of the shareholders which would be difficult in a fragmentation context; it also involves the liquidity and the readability of their capitalisation, thus of their capacity of external growth.

4. The FBF wishes to highlight that the discussions engaged on the Equity markets transparency were based on several statements which are not relevant, neither on the bond markets, nor on the derivatives markets :

- The centralisation of transactions and the maturity of the trading venues;
- The permanent flow of financial information concerning issuers (from both Medias and publication of periodic accounts) which largely defines the investors' behaviour on the sell side or on the buy side;
- The importance of the retail market (on Euronext markets, for example: almost 30% of transactions and 10% of the volumes traded).

5. The FBF takes the opportunity of the "call for evidence" to give its contribution on the reflexion concerning the relevance of implementing a mandatory transparency on Bonds markets and on Derivatives markets. As this stage, the FBF considers as a necessity to clearly distinguish the Bonds markets, whose architecture have been largely studied and analysed during the past few years, from the Derivative markets, which have never been in the heart of the discussions and of the academic or institutional papers.

6. As preliminary remarks, the FBF wishes to make three statements.

First, the FBF is convinced that contrarily to the equity markets which have had a major evolution during the nineties and the beginning of the 21st century, the bond markets and the derivatives markets are still concentrating and developing. Thus the enforcement of mandatory rules could be at least premature and detrimental to their development.

Second, the FBF is also convinced that the future conclusions of the European Commission have to take into account the major differences existing between these markets and the Equity markets.

Third, the FBF is convinced that the integrity and the prevention of market failure depend on the two following factors: the fair competition between dealers and the liquidity. The transparency is a consequence of the combination of these two factors, but is not a precondition.

DETAILED REMARKS

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

The FBF agrees with the scope of the Report proposed by the Commission and also agrees with the willingness of the Commission to consider more than one outcome to its options for intervention.

Indeed, the regulation cannot be envisaged identically since the impact of similar provisions will have far different consequences according to the types of instruments considered and the organisation of the related markets. Especially, the nature of Derivatives products and the architecture of the markets are not homogeneous.

The FBF estimates that the principle of differentiated transparency across class or specific classes of non-equity is fundamental and that a specific regard must be paid to the associated costs and burdens that a tailored transparency regime for specific non-equity products could create. Therefore, the FBF recommends that the Commission analyses in detail the relative merits, costs *versus* benefits, of such a differentiated approach as proposed in the “*Call for Evidence*”.

The FBF also welcomes 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.

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

The FBF considers this classification as sufficient. Two elements are to be taken into account:

- First, the limits of the Commission’s resources to investigate each market in detail, as the “*Call for Evidence*” notes, which implies that the Commission will be able to drill down to the level of detail necessary to set up the relevant provisions which will take full account of the different natures of the non-equity markets;
- Second, a more detailed classification could break innovation by restricting conceptual and practical flexibility.

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

No. The FBF considers that the possible policy rationales for imposing mandatory transparency set out in the call for evidence and grouped under the headings of Investor protection, Market efficiency and Response to Technological Developments are comprehensive.

The FBF however suggests that each element should be considered in the context of a market failure analysis on which, in recent months, new and reliable information has been published by, for example, the Centre for Economic Policy Research¹.

¹ « *European Corporate Bond Markets : transparency, liquidity, efficiency* », may 2006, and « *European Government Bond Markets : transparency, liquidity, efficiency* », may 2006.

The FBF also approves the willingness of the Commission, as discussed in section 5, to consider a range of options for intervention in the event that a market failure is identified, including 'no change' and reliance on self-regulation as possible alternatives to the imposition of mandatory transparency.

Overall, the Commission has to take into account the fact that the requirements to be extended to some non-equity products must be the trade-off between protecting investors and creating a policy framework to allow for efficient markets. Especially, the transparency could be detrimental to the liquidity on these markets.

The high degree of investor protection depends largely on the liquidity and on the prevention of a market failure (such as systemic risk or credit risk). The more efficient is the market, the higher is the investor protection.

Concerning the technological developments, the FBF underlines that if they might facilitate some forms of mandatory transparency, they do not justify it. In other terms, technological developments are a means to an end, but should not by themselves be the main driver of the regulation.

Moreover, considering the experiences and the practices of the non-equity markets, there is no evidence of market failures which should justify the setting up of mandatory transparency rules.

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

Yes, the FBF approves the sensitive approach of the Commission which proposes to set priorities for its review of non-equity markets. Indeed, not all class of non-equity products or their markets are characteristically uniform, nor is retail investors' exposure to those products or markets.

Nevertheless, the FBF notices:

- First, that the Commission should keep both objectives of market efficiency and investor protection in mind when considering the appropriate level of transparency in markets;
- Second, that a clear distinction must be made 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;
- Third, that price transparency is not the most relevant way to ensure investor protection;
- Fourth, that the prioritisation of the cash government bond market seems inappropriate given the current high levels of pre- and post-trade transparency that currently exist and the mathematical basis on which prices are determined. If problems do exist in the Government market, and the CEPR study of Professor Richard Portes identified some, it does not appear that mandatory transparency would resolve or ameliorate them, and according to Professor Portes could make matters significantly worse. The FBF remarks the professor writes in his report that: "*The very existence of most financial markets depends on striking a balance between transparency, thought to promote competition, fairness and investor protection, and opacity, in the interest of encouraging ongoing participation of both end-customers and liquidity providers*". This statement seems relevant in a general context.

5. To what extent do you consider there to be:

- a. observable or demonstrable problems with respect to the possible policy rationales for 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?**

The MiFID is largely an investor protection oriented Directive. We can measure the degree of investor protection by the rules applying to intermediaries, such as the Best execution principle and the Investment advice which becomes a core investment service submit to license.

Moreover, the pre and post-trade transparency applicable on Equity markets, if it seems natural for these markets due to their structure, is not really an investor protection and sometimes not a at all a liquidity-oriented measure.

Indeed, it has always been recognised that the actors met the limits of transparency benefits in two cases:

- Block trades which need confidentiality; the block trades on equities and traded over the counter at conditions outside the price discovery process of the regulated market;
- The illiquid shares, which need market makers who have an essential role by putting up capital and ensure a minimum degree of liquidity.

But these two cases, which constitute, in number, the exception on Equity markets, are clearly the major cases on Bonds markets. Structurally the Bond market efficiency needs a certain degree of confidentiality and a high level of competition between "market makers".

Two rationales are to be studied:

① Market Efficiency

The more recent research (the two studies published in May 2006 by CEPR and the FSA feedback statement of July 2006) bring a view of well working market forces in the bond. These well working market forces are the high degree of competition between actors, the rapid technological and market growth and developments, including, where appropriate, an increasing degree of pre- and post-trade transparency.

These studies don't bring any evidence that those markets are not capable of delivering satisfactory level of transparency.

Thus if the FBF is cannot assert that the pre and post trade transparency will certainly be detrimental to the liquidity on these markets, the risk exists, while there is no objective element to show that such mandatory rule would encourage the market efficiency nor the investor protection.

The FBF notices that the CEPR study does not close the door to a certain degree of post-trade transparency, but the impact of such a rule on liquidity involves the necessity of being very careful. Overall, it seems necessary to let the lead on this transparency to the market forces.

The FBF notices also that the studies only cover the sovereign and investment grade corporate debt markets but don't tackle the issue of high yield and other debt instruments. Thus it would be useful to engage such an impact study on these markets. Especially, the high yield market is characterised by its relative illiquidity, and the asset backed securities market is characterised by a very complex nature. However, these markets evolve rapidly and are very competitive.

② Investor protection

The two critics are mainly expressed concerning the investor protection:

- First, the inappropriate levels of retail exposure to sovereign or corporate defaults;
- Second, the very low level of direct (as opposed to indirect, through investment funds) retail participation in bond markets.

The FBF sees no evidence that these problems can be solved by transparency rules.

On the first point, the FBF believes that the implementation of MiFID is the proper regulatory tool for managing this risk, notably the effective enforcement of the new investment advice as a core investment service and best execution provisions. The intermediary is fully responsible before its customer and he is also the actor who determines the market transactions.

On the second point, it doesn't seem obvious that a greater transparency could be a strong factor in determining participation of retail investors, for the facts show that retail investors who buy bonds hold them for the long term, rather than trading them actively. As a matter of fact, the increase in direct participation of retail investors in the Bond markets raises a series of questions going far beyond a price transparency issue, and which relate primarily to marketing, investment advice, and investor education. On this context it seems natural to promote investment funds rather than directly bonds, for the funds have a risk dilution nature whose function is to prevent credit risk.

We agree with the conclusion in the FSA feedback 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"*.

The recent studies highlight the complex relationship in the bond markets between transparency and liquidity. Not only higher transparency does not ensure a greater liquidity, but an excess of transparency may have detrimental effects on liquidity, thus reducing the overall efficiency 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 and because investor request prices from different dealers before trading and compare those prices.

In terms of *post-trade* transparency, the FBF also has 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.

- 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 above, the recent studies, especially the CEPR research, show that all of the markets under review are experiencing rapid technological and market growth and development, including, where appropriate, an increasing degree of pre- and post-trade transparency. The market forces lead naturally these markets to a greater transparency which is tailored to the market need.

Fromm FBF's point of view, another element to be taken into account is that the Industry is currently faced with the significant prospect of implementing the technological systems to be compliant with MiFID by November 2007. Time is needed for every actor to ensure the efficient operation of MiFID systems before any extension could be considered.

It must be noted that while equity markets are mostly electronic, non-equity markets are structurally OTC so the costs incurred for transparency provisions would be on a much higher scale.

- 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?**

The major part of the response is discussed under the question 11. The FBF underlines that the main differences between equity and non-equity markets have been well documented in the evidence cited in the research reports listed in the bibliography to the call for evidence:

- The Equity market is very liquid while Bond market is relatively illiquid;
- The Equity market is relatively small, while Bond market is large;
- The secondary market is predominant on Equity markets, thus there is a high frequency of trade, while the primary market is predominant on Bond market; thus there is low frequency of trade.

It seems obvious that in consequence the degree of transparency of these markets must differ.

What is also obvious is that it is very difficult to imagine the equity markets without any mandatory rules on transparency. This is a huge difference: the fact that there is little mandatory transparency in bond markets doesn't mean that there is no transparency at all. It just demonstrates transparency arises from market forces. The FBF notices that there is already a satisfactory transparency in bond markets as evidenced by the absence of market failures, by the fierce competition between actors and by a general absence of complaints from investors.

- 8. What data sources do you consider relevant to the issues you have raised (if appropriate, cross-refer to your answers below)? Would you or your organisation be prepared to produce any relevant data if necessary?**

The FBF notes that the data sources listed by the Commission and the CEPR studies reflect the corpus of information on this subject that is currently available and in the public domain. Nonetheless, the FSA Feedback Statement on the discussion paper 05/05 on

“*Trading Transparency in the UK Secondary Bond Markets* » (FSA 06/04, July 2006) has to be taken into account.

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

Yes. The FSA Feedback Statement (FSA 06/04, July 2006).

10. What conclusions do you draw from the existing academic debate and the ongoing work being conducted by the interested parties?

Because the US market and the European markets largely diverges, the FBF believes that the Trace academic work on transparency in the US corporate bond markets is not applicable as is to the reflexion in Europe.

The main reason why it is not applicable is that the impact of TRACE on transactions costs for corporate bonds is unlikely to be mirrored in Europe, for bond markets in Europe already have tighter spreads than the US, and for European markets tend to have greater pre-trade transparency with more dealers prepared to commit more capital in offering finer prices in larger sizes.

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

On a first hand, as it is stated above, the French industry has always encouraged the pre and post-trade transparency on Equity markets. On the other hand, the French industry is convinced that the different non-equity markets under review are structurally different from the Equity markets.

The market efficiency is not completely based on the same factors and the price discovery does not follow the same process:

- First, while equities trade on the unique dynamics of a particular company's future prospects, bonds are generally traded within groups according to their credit rating, maturity and yield; their price is therefore generally a much simpler mathematical calculation;
- Second, there are many more bonds than equities and that unlike equities bonds, even those issued by different issuers, can often be good substitutes for each other. In consequence, bond markets are much less concentrated than equity markets. – there are some 8000 listed equities in the EU but over 200,000 bonds (source: ICMA's TRAX database).
- Third, most investors in bonds buy and hold to maturity. Trading activity is concentrated in the first days of issue. Whereas an equity investor must deal almost exclusively in the secondary market to buy and sell a share, a bond investor can buy a bond and wait until redemption. Bonds therefore trade infrequently compared to equities. In a recent data sample, only about six non-government bonds (from a total of over 5,000 that traded on one day) experienced 200 or more trades a day. Unlike equities those six bonds will differ week by week.

Moreover, one of the main difference is that unlike cash equities there is no central or dominant pool of liquidity in bond markets, except in the most highly liquid of markets, such as certain government bonds.

The academic literature on cash equity markets generally views this lack of concentration as a weakness. But because most bonds do not trade frequently, there is never a constant source of buyers and sellers looking to trade sufficient to sustain a central pool of investor provided liquidity. Investors rely on the ability of dealers, individually or collectively via telephone or e-trading systems, to assume the risk inherent in intermediating the timing differences between buyers and sellers. Liquidity is thus very dynamic and much more so in fixed-income than in equity markets. Dealers sell securities from, and buy securities into, their trading portfolios. Many such dealers provide liquidity to their clients by buying bonds from them even though they do not have and may not find an ultimate buyer to which to on-sell the bonds. Most of their trades are therefore done on an at-risk basis; i.e. they do not have both a buy and sell order at the time they enter into a transaction. What is a weakness on Equity markets is strength on Bond markets.

Therefore the FBF strongly believes that the academic or institutional literature concerning transparency in the cash equities markets is not relevant in this context.

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 FBF underlines that the most important conclusions as regards possibly applying a TRACE-like system in Europe can be drawn from the relevant CEPR research.

Furthermore, the US Trace experience indicates that excessive transparency has led to a reduction in capital commitment by dealers. This has created an increased competitive advantage for the larger institutional investors which are able to exert leverage on their dealers to continue to provide them with firm quotes at the expense of smaller institutions and retail brokers. And at last, the spread remains larger than in European Corporate Euro Bond markets.

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

As it is stated above, the most important way the MiFID takes to ensure investor protection is the implementation of the best-execution principle and the financial investment advice as an investment service. Thus the FBF does not believe the EU level intervention would be warranted at this stage.

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?*

As a general remark the FBF strongly believes that the market efficiency depends on the liquidity of the market which depends on the degree of competition between many actors. Thus the transparency depends on this market efficiency, for the current trend of increasing pre-trade and post-trade information is clearly tied to the degree of competition and of liquidity.

The FBF considers as obvious that the degree of pre and/or post trade transparency will adapt accordingly to the future evolutions of the markets.

15. In respect of both pre- and post-trade transparency, are the four options the right ones to consider, and in particular should other options be considered?

The FBF believes that the four options are the appropriate ones, but nonetheless estimates that the last two options have to need very carefully studied, for their implementation could be detrimental to the liquidity of the markets.

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;**
Any other financial instrument you consider relevant.

The FBF made several statements on the bond markets which show the fundamental differences between these markets and the Equity markets:

- First, the over the counter (OTC) » nature of these markets: the transactions are concluded through bilateral engagements, with no client order books, contrarily to the equity markets;
- Second, the price formation depends on mathematics elements which depend on exogenous factors, regarding to the issuers.
- Third, it's a wholesale market, with no significant retail market share;
- Fourth, the primary market is largely predominant to the secondary market, even for the most liquid bonds.

The FBF firmly believes that these statements are even more relevant on the derivative markets, for the OTC market on these products is based on tailor made products chosen by the institutional either for coverage of an economic risk, or for a speculative investment policy they are setting up considering their capacity to understand the risk these products involve.

That's why the self- regulation is the primary mechanism for securing fair and efficient derivatives markets. Thus the FBF favours the "no-change" option in terms of transparency rules.

Moreover, these markets are more heterogeneous than the Bond markets. Thus the FBF advocates caution in comparing the derivatives markets and consequently seeking to analyse experience from one market to apply to the other.