European Capital Markets Institute

Organised trading for non-equity financial instruments: The MiFID Crusade

European Parliament - Brussels
23 March 2011

MEETING REPORT

The structure of today's financial markets is undergoing important changes and reforms. As result of the financial crisis, policy makers are striving to balance efficiency with transparency and market stability. In particular, proposals to push non-equity asset classes (such as bonds, structured products and OTC derivatives) towards more 'organised' trading run by exchanges, MTFs and alternative trading platforms have raised concerns on how this process can be efficiently pursued. Specific characteristics of more complex markets, such as over-the-counter derivatives markets, may involve side effects, since unbalanced regulatory actions may change dealers' incentives to commit capital for trading execution. The conference discussed these issues and forthcoming regulatory reforms with policy makers, regulators, academics and market practitioners.

Keynote Speech: Benefits and Costs of Organised Trading for Non Equity Products

Thierry Foucault, Professor of Finance, HEC University Paris

- Follow this link to download the presentation by Thierry Foucault

Mr. Foucault explained that the transition from OTC trading to electronic trading for standardized OTC products is a big step. He believes that improving post trade transparency is likely to be beneficial. However, benefits are less clear from the point of view of pre-trade-transparency, given the low level of activity in some of these securities. Mr Foucault stressed the lack of sufficient empirical studies on this type of switches.

Mr. Foucault believes enough attention needs to be paid to the design of the trading platforms for relatively inactive derivatives (for instance one may solve the competition/order exposure tension with trading systems in which multiple dealers respond simultaneously to a quote request). He suggested letting the industry experiments with various format for the trading platforms. Finally, he also suggested conducting pilot experiments, which would help to assess the effects of the proposed changes on measures of market quality and would also help the industry to prepare to the new environment.

Panel I: THE REGULATORY VIEWPOINT

Organised trading: striking the right balance between efficiency, transparency and market stability

- *Gunnar Hökmark, MEP*
- *Maria Velentza, Head of Unit, Securities Markets, European Commission*
- *Thierry Foucault, Professor of Finance, HEC University Paris*
- *Martine Doyon, Head of International Strategy, Financial Services Authority*
- *Diego Valiante, Research Fellow, CEPS and ECMI*

Ms. Velentza explained that the intention of the European Commission is to comply with its G20 commitments and not to move trading by enacting a concentration rule. In addition, the Commission seeks to propose legislation that is time-resistant and coherent with US regulation, as recently revised in the Dodd-Frank Act.

Ms. Doyon explained that the effects of more transparency are difficult to forecast since they are very sensitive to the type of instrument and the mode of trading. She believes that the changing nature of financial markets means that any transparency regime devised today will become dysfunctional over the medium term. The most sensible alternative, according to Ms. Doyon, would be to follow a phased approach to the introduction of organised trading for non-equity products.

Mr. Valiante pointed at the lack of definition of organised trading and warned about the creation of new legal categories (organised trading facilities, OTFs) on the basis of covering venues for non-equity financial instruments. The definition of multilateral trading facilities (MTFs) can be accommodated to cover all platforms already in place for non-equity financial instruments (recital 6, MiFID). The transparency regime (pre and post) can be then refined by asset class. Conversely, creating different sets of definitions and principles could generate regulatory arbitrage.

He also suggested regulators to clarify the MiFID conditions for a trade to be considered OTC. If these conditions apply to parent (instead of child orders), broker-dealer crossing networks (BCNs) could exist as they do now. Mr. Valiante believes BCNs should not be forced to convert into MTFs, given they follow a different business model (hybrid) and perform a different function. Yet, Ms. Valentza said BCNs should operate with a level of transparency similar to MTFs, given that – in her view – they both perform similar functions. She also mentioned that the introduction of OTFs is still under discussion.

The Investment Management Association (IMA) urged the Commission to propose a consolidated tape for non-equity instruments. Ms. Velentza explained that the Commission is willing to introduce this tape for equities without leaving it in the hands of the industry. She also said that the Commission wants to engage in this debate outside equities.

Mr. Hökmark stressed the need for the European Parliament to regulate financial market but also to follow clear objectives and avoid any form of overregulation. He warned against considering financial markets separate from the real economy. In his view, this dichotomy is artificial since financial markets are meant to finance the real economy and spread risks. Mr. Hökmark argued in favour of enhancing this contribution to the real economy and warned against any excess, both from the markets and from the regulators.

Panel II: THE MARKET VIEWPOINT

Will reforms favour a paradigm shift in market structure? What are the main ways 'to organize' trading? What type of non-equity financial instruments will be ready to move on these platforms? Is the market ready to change? Where will the risk lie for organised trading then?

- *Carlos López Marqués, Deputy Director, International Affairs, BME*
- *Mike Sheard, Director Corporate Affairs, ICAP*
- *Eric Kolodner, Managing Director, Tradeweb*
- *Robert D. Ray, CEO, CME Operations Ltd*
- *Paul Christensen, Managing Director, Principal Strategic Investments – Market Structure, Goldman Sachs Int.*

Mr. Ray believes stressed that the regulation of non-equity financial instruments needs to be reformed to improve the functioning of the market and reduce systemic risk. He favours bringing in more transparency and standardisation but warned against one-size-fits-all approaches. He pointed as regulatory arbitrage and extra-territorial effects as two of the main hurdles.

Mr. Kolodner explained that, in the dealer-institutional market where Tradeweb operates, there are three factors to take into account: (1) trading venue, (2) trading protocol and (3) trading transparency. MTFs emerge as the preferred trading venue for derivatives but no single trading protocol does, which means there is a need for flexibility. As to trading transparency, Mr. Kolodner highlighted the difficulties in determining which data is published, by which entity and for which addresses.

Mr. Sheard explained that markets have been moving to electronic trading for years, market segment by market segment. He clarified the differences between OTC and non-electronic trading. Mr. Sheard favoured a flexible approach by regulators, which should seek to avoid thresholds and take into account the need for liquidity.

Mr. López Marqués spoke of a change in paradigms when it comes to the division between multilateral and bilateral trading. He explained that the implementation of the MiFID categories of trading platforms has not been fully consistent. Mr. López Marqués stressed the importance of OTC trading in Europe, which seems to account for half the trade carried in the Continent.

Mr. Christensen warned against the standardisation of all OTC products which could make hedging very expensive or impracticable for many companies. He warned against one-size-fits-all approaches but explained that the introduction of a new type of venue could lead to liquidity fragmentation. Christensen argued in favour of the new rules being gradually phased in to allow markets to accommodate, given the depth of the changes sought.

For more information

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These exchanges are fuelled by the publications ECMI regularly produces for its members: quarterly newsletters, annual reports, a statistical package, regular commentary and research papers, as well as occasional workshops and conferences. ECMI also advises European regulators on policy related matters, acts as a focal point for interaction between academic research, market sentiment and the policy-making process, and promotes a multidisciplinary and multidimensional approach to the subject.

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