
Briefing Note

MiFID Review – Fixed Income

BN-11-03

Last updated: July 2011

Overview

The Markets in Financial Instruments Directive (MiFID) was designed to bring efficiency to the European Equity market through competition and to ensure that investor protection was consistently achieved across national boundaries. The MiFID review has now been significantly expanded and introduces new requirements for non-equity products.

AFME believes that the EC should not transpose a regulation designed for the equity markets onto the non-equities markets. Many Non-equities markets are fundamentally different from the equity markets, and within non-equities the asset classes differ enormously. AFME warns against unintended consequences that could result from applying the same regulatory requirements across all asset classes even if attempts are made to calibrate. This paper summarises the views and concerns of the investment grade, covered bonds, rates, securitisation, and high yield dealer members of AFME.

AFME'S Position

Non-Equity Markets Structure

The MiFID review proposes to capture a broad range of non-equities trading under the new definition of an Organised Trading Facility (OTF) and requires an OTF to convert into a Multilateral Trading Facility (MTF) at a particular threshold.

AFME is concerned about suggestions to force non-equities trading onto organised venues or systems. Different trading models exist to account for and facilitate the diversity of non-equity products and the needs of investors; therefore, new market structure definitions need to reflect these differences.

Organised Trading Facilities (OTF) - scope must be clearly defined

We are concerned that the scope of an OTF is too loosely defined. A definition of an OTF that captures the majority of non-equity trading systems and facilities reduces flexibility and investor choice. The MiFID review does not differentiate between the range of products and trading models present in the non-equities markets, including block-trading and private trades. AFME recommends an approach that appreciates the diversity of trading in the markets. Systems that only provide investors with indicative prices or are aimed at facilitating investor requests for quotes (i.e. price discovery systems) should not be caught by the definition. Only systems designed to match and execute trades (i.e. execution venues) should be incorporated within the scope of the OTF definition.

Forcing trading onto OTFs and MTFs – freedom of choice should be maintained

In addition to the new definition of an OTF, the EC proposal requires all OTFs to convert into MTFs above an asset-class based threshold. We believe a top-down approach, prescribing markets to use OTF or MTF systems, is highly disruptive. Broad definitions and thresholds that force markets to adopt particular trading systems or venues lead to a reduction in competition, a lack of innovation to meet end user need, a lack of liquidity in periods of market stress, and the reduction of market efficiency. Markets need to have the freedom to allow end users to choose the most suitable platforms for individual products and sectors. We believe the existing flexibility in trade execution methods

enables market participants to provide and access liquidity through non-electronic platforms in times of market stress and also allows markets to move to electronic platforms in normal market circumstances.

Also, the MiFID review suggests that the OTF-MTF threshold should be volume-based. We believe that volume is not relevant for deciding the venue of a transaction.

Automated Trading - problematic definition

Defining automated trading as the use of a computer programme to determine any aspect of the execution of the trade is too broad, as it captures almost all trading (e.g. simple auto-reply, routing systems). The definition should specify that the computer algorithm not only makes the execution decision but also initiates the actual execution without manual trader intervention.

High Frequency Trading (HFT) should only involve trading which is proprietary in nature. Therefore, a broker acting as an agent to a client should not be defined as a HFT.

Should firms using automated trading have to provide too much detail as part of their notification requirements, it would cause a number of problems, including intellectual property difficulties. Also, we question the usefulness of providing excessively detailed information to the authorities.

Transparency – ensure that rules are tailored to each market

AFME encourages transparency. However, we strongly believe that any transparency requirements should be specific to each asset class and that appropriate safeguards must be put in place to protect liquidity. Furthermore, the information produced must be meaningful to the market and the benefits must outweigh the significant costs involved.

Pre-trade Transparency - information already available to investors

AFME believes that additional pre-trade transparency requirements are not necessary for the non-equity markets. Indicative quotations, websites, dealer-runs and various platforms already provide investors with a sufficiently large amount of pre-trade information. For further information on specific firms and vendors that provide this information, please see the AFME Price Discovery Guides (see Further Documents).

In our view, making further price information available to dealers and non-buy-to-hold investors could impair liquidity and increase margins. In particular, too much transparency may disadvantage market makers when reselling their products; therefore, they would be less willing to accept the greater risk and would demand a higher price. Specifically, to the detriment of both investors and dealers, execution of large trades would be made more difficult.

Furthermore, AFME believes that dealers should not be required to make any pre-trade pricing firm (i.e. executable). In many markets this is not practicable due to risk management constraints. The provision of non-firm indicative quotes is an essential service to investors and enables dealers to adjust prices to market circumstances. If indicative quotes had to be made firm, dealers would be reluctant to quote prices, which would be detrimental to investors.

Additionally, banks are not set up to provide real-time quotes on bonds that do not actively trade; therefore, such an obligation would be costly and could potentially create an additional barrier to entry for new market participants.

Lastly, AFME supports CESR's technical advice on pre-trade transparency in so far as it does not prescribe any pre-trade requirements for the OTC markets. We would like to understand why the EC has diverged from CESR's recommendations and what specific market failure the EC is seeking to address.

Post-trade transparency – delays needed to protect dealers and clients

AFME is concerned about both the EC and CESRs' suggestions on post-trade transparency.

Non-equities consist of a broad range of products, even within asset classes, and therefore, the scope of the post-trade transparency requirements in addition to calibration must be considered.

Scope and calibration, including reporting delays, should not be determined by trade volume alone; average turnover, issuance size, number of tickets, and age of issue must all be considered. We believe the thresholds recommended by CESR are not suitably calibrated to actual trading levels (see the analysis of Xtrakter data on page 46 of the AFME response).

Lastly, a post-trade regime without a comprehensive impact analysis or implementation in phases may not be prudent and may further exacerbate market pressures and diminish liquidity.

Ban on Specific Activities, Products or Practices

We fully support the EC's objective of enhancing market stability. However, the proposal to regulate products in addition to investment activities and services may have significant unintended consequences, such as loss of market confidence, and may also be difficult to put in practice. Generally, the causes of market instability are complex and cannot be easily determined, let alone be attributed to one specific instrument. Individual products in themselves cannot be considered high risk or "bad" per se, and in particular, there is often a false link made between complex products and its associated level of risk. The MiFID definition of complex products relate to the ease with which the product can be understood by an investor, rather than its market risk. In reality, however, a complex product can have a lower market risk than a non-complex product. Products are used in different ways, and it is this use of the products that determines their risk. Also, historically, it has been difficult to determine which products should be prohibited. Finally, any ban should be subject to extensive market failure analysis.

Further information

MiFID is an extremely complex and comprehensive piece of regulation. AFME has broken down positions on the key issues in more specific briefing notes:

- [BN-11-01 MiFID Review Briefing Note Overview](#)
- [BN-11-02 MiFID Review Briefing Note – Equities including market structure issues, venue definition, high frequency trading etc](#)
- [BN-11-03 MiFID Review Briefing Note on Fixed Income including price transparency](#)
 - BN-11-03A MiFID Review Briefing Note on Rates (yet to be published)
 - BN-11-03B MiFID Review Briefing Note on Credit (yet to be published)
 - BN-11-03C MIFID Review Briefing Note on Securitisation (yet to be published)
- [BN-11-04 MiFID Review Briefing Note on FX](#)
- [BN-11-05 MiFID Review Briefing Note on Corporate Finance](#)
- [BN-11-06 MiFID Review Briefing Note on Compliance including data consolidation, transaction reporting, investor protection, ESMA and Access of Third Party firms.](#)

See also briefing notes covering AFME led initiatives:

- [Post Trade Transparency Framework for Fixed Income](#)
- [OTC Equity Trading Report](#)

AFME's response to the MiFID Review Consultation can be found [here](#)

AFME contacts

Sander Schol

Director, Rates products

P: +44 (0)20 7743 9352

F: +44 (0)20 7743 9301

M: +44 (0)7775000891

sander.schol@afme.eu

Rick Watson

Managing Director, Capital Markets

P: +44 (0)207 743 9333

M: +44 (0)7795 242 130

F: +44 (0)207 743 9301

rick.watson@afme.eu

Association for Financial Markets in Europe

St Michael's House

1 George Yard

London EC3V 9DH

Tel: + 44 (0)20 7743 9300

www.afme.eu