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## **UPCOMING REVISION OF THE MIFID DIRECTIVE ON ARCHITECTURE OF THE FINANCIAL MARKETS**

### **FRENCH BANKING FEDERATION'S POSITION**

#### **GENERAL COMMENTS**

#### **1. Reform of the MiFID must focus on the markets' architecture**

**For French banks, reform of the MiFID directive's market regulations is a major European legislative issue for the coming months.**

This directive was the cornerstone of the first Financial Services Action Plan, insofar as it sought to address the entire financial-intermediation sector, from trading activities to distribution to retail investors.

For European markets, reform of this directive must not only be the result of experience acquired during two years of implementation, which is a brief observation period, but also - and more importantly - a European response to problems raised by the economic crisis. This response must take into account agreements made internationally under the auspices of the G20 and measures taken in the United States, among others, in order to prevent competition distortions among financial markets.

**It involves the structure and operation of both markets and post-trade infrastructures, where relevant (data centralization, central clearing counterparties and settlement systems), must serve as the benchmark for what constitutes an organized, efficient market, and must have a clearing infrastructure that prevents systemic risk.**

Such architecture may justify favourable prudential treatment of those market activities that use it, given that the crisis has put the prudential standards applied to banks front and centre.

In this context, French corporate and investment banks (CIBs) have much to gain from the creation of such architecture for the instruments it applies to, according to the characteristics of such banks' trading books. This therefore corresponds to their risk awareness, size in the markets and financial-instrument distribution model (simplicity of

instruments). It also allows them to promote their activities where they have strong positions (derivatives, including equity derivatives) for which they need high levels of underlying market liquidity.

Capital requirements, as they will be defined in the new CRD, and awareness of systemic risk must also take into account reduction of market risk and therefore the use of clearinghouses.

**However, with regard to aspects of the directive concerning distribution and investor-protection rules**, the crisis and the resulting sharp decline in France's individual equity market investor numbers have made it difficult to assess the effectiveness of a process that was in fact very complex and costly to implement. **There is felt to be no need for reform** with regard to these aspects. **Only the issue of client segmentation creates real problems today**: the paradox is that large corporate investors want to be treated as individuals, yet routinely refuse the formalities (suitability tests) that this choice implies.

## **2. Reform must involve stock, bond and derivatives markets, but via different approaches**

In terms of market regulation, a distinction must be made between:

- Reform elements of the directive implemented on 1 November 2007, whose unexpected effects on stock-market operation have already been noted (fragmentation, opacity and volatility).

And:

- Reform elements resulting from market problems themselves, caused by the financial crisis but not related to the entry into force of the MiFID directive, which concerns the bond and derivatives markets.

### **• Equity market reform aimed at correcting competition-condition asymmetry**

The foundation of the MiFID directive was in fact an analysis of equity markets and their functioning, based on the monopoly enjoyed by the stock exchanges, either in law or in fact. It should be recalled that, in accordance with the ISD of 10 May 1993, States had the power to impose an obligation to concentrate orders on the regulated market until the MiFID directive's entry into force.

The objective was to achieve "*an effective, transparent, integrated trading infrastructure.*"

To this end, the philosophy of the MiFID directive was based on three-pronged reasoning:

- The stock exchanges' monopoly (as long as it continued) did not allow investors to benefit from lower trading costs resulting from market computerization in the 1990s.
- Competition created between stock exchanges and other market operators would cause the decrease in trading costs to have an effect on intermediation costs incurred by investors.

- Due to the opening up of competition among various market operators, pre-existing rules relating to investor protection prior to order execution and to execution itself had to be reinforced (by the creation of a "best execution" obligation).

During all the MiFID directive's preparatory work, French banks defended pre- and post-trade transparency rules, which were needed to prevent information asymmetries between intermediaries and investors. Competitive distortions, whether real or imagined, the impact of fragmentation on the price discovery process and, to a lesser degree, the directive's allowable exceptions have been the source of most formal criticism since then.

Without calling into question the competition created by other operators for regulated markets, French banks feel that it is necessary to implement reforms that prevent the information and competitive-condition asymmetries that have appeared since the directive became effective. Indeed, the directive itself has brought about asymmetries on the equity markets and not the economic crisis, which, although it has made the markets much more volatile, has not adversely affected their efficiency in terms of liquidity or resilience.

- **A calibrated reform specifically for bond and derivatives markets**

With regard to the markets, the MiFID derivative focused primarily on the equity market, even if certain provisions concerned the bond and/or financial-futures markets.

Unlike the equity market, these latter markets are essentially wholesale markets, and do not involve retail clients for the most part. If some malfunctions have been noted, they are linked to the economic crisis and not to the MiFID directive's implementation.

Given bond markets' specific nature (mainly buy and hold markets), the liquidity of the secondary market has never been high, particularly for corporate issuances. In this respect, the crisis has worsened a pre-existing situation. However, primary corporate bond issues were at very high levels in 2009.

On derivatives markets, the problem stemmed from credit derivatives, where the entirely over-the-counter market had serious flaws, further leading to a concentration of systemic risk. The crisis has highlighted the need to boost transparency, standardization and centralized clearing.

The malfunctions noted in these markets are therefore quite different from the asymmetries detected on equity markets and also merit different responses.

### **3. Pragmatic reform proposals that can be quickly implemented**

The effectiveness of MiFID-directive reform will be tied to its pragmatism and the relative speed at which it is implemented.

**Stock markets:**

- *Extension of pre-trade transparency to all orders regardless of trading venue (including dark pools), other than for blocks exceeding a predefined threshold.*
- *In high-frequency trading, no position that is systematically favourable to a reduction in time tick sizes, but agreement on the idea of a study and possible harmonization in Europe.*
- *General implementation of post-trade transparency based on a common infrastructure, which can serve as a reference for both public data and the regulator.*

**Bond markets:**

- *Calibrated, centralized post-trade transparency.*
- *An incentive for an industry initiative to implement mechanisms for improving the liquidity of secondary markets.*

**Derivatives markets (priority given to credit derivatives):**

- *Prudential incentive to harmonize contracts, and centralized clearing via preferential capital treatment of derivatives cleared on CCPs (rather than the implementation of punitive treatment for derivatives cleared bilaterally).*
- *Implementation of central clearing counterparties supervised by the central bank issuing the currency in which the derivatives are denominated.*

French banks intend to structure their proposals according to the following principles:

- **Stock markets**

On stock markets, the priority is to improve pre- and post-trade transparency, except for block trades, with analysis needed to define block thresholds.

**French banks support the following positions:**

- *Extension of pre-trade transparency to all but blocks orders, regardless of the venue on which they are executed, which has the advantage of contributing to equal information among all investors, but could alter the conditions under which institutional orders are executed by opening up the market to arbitrageurs.*
- *Reinforcement of ex-post supervision for all trading venues (including dark pools).*

- **Regarding the use of high-frequency trading, no position that is systematically favourable to a reduction in tick sizes, but agreement on the idea of a study and possible harmonization in Europe.**
- **General implementation of post-trade transparency based on a common infrastructure, which can serve as a reference for both public data and the regulator, thereby leading to:**
  - o Clarification and harmonization of reporting rules.
  - o Creation of a European entity charged with consolidating execution data in real time. This single, central organization would also be responsible for making data available, collecting associated revenues and defining a method for redistribution to the infrastructures based on the volumes and quality of the information collected.
- **The US solution of routing orders is not desirable for Europe**

In fact, the implementation of a system for strengthening pre-trade transparency accompanied by mandatory routing of orders to the market offering the best price is not desirable: a European Best Bid Offer (EBBO) mechanism, based on the RegNMS operating method, does not appear to offer clear benefits. Restrictive for all players in terms of investments, it puts up significant barriers to entry for both markets and intermediaries (via necessary investments in the SOR). Moreover, in the absence of consistent post-trade regulation, this can mean that trades are cleared in clearinghouses with weak guarantees.

However, an EBBO provided for information purposes might perhaps serve as a standard for best execution, but only if accompanied by a change in the best-execution mechanisms that allow latitude (to be defined) vis-à-vis the best price.

- **Bond markets**

For bond markets, the aim is to boost post-trade transparency and improve the secondary market's liquidity conditions. Given the nature of these markets, we should focus here on transparency (perhaps organized by the European legislator) in liquidity (which, for its part, is first and foremost a function of industry initiatives and not directly tied to the MiFID directive's revision).

Two areas of reform are therefore proposed:

- **Post-trade transparency that is calibrated** (definition of the trade amount beyond which it does not apply and of the post-trade declaration period, and calibration based on the bonds in question, whether government or corporate) **and centralized.**
- **Incentive for an industry initiative to implement mechanisms for improving secondary markets' liquidity** (via offer centralization and matching of buyer and seller interests). In France, several initiatives are being discussed.

- **Derivatives markets**

With derivatives, a sufficiently centralized architecture needs to be defined for European markets (involving standardization, clearing and information) to allow European financing and investment banks to prevent systemic market risk.

To this end, the creation of one or more clearinghouses for derivatives should be encouraged for the euro zone, and clearinghouse governance standards that reflect their “Utility” character and promote cross-zone concentration should be put in place. The system must be incentive-based and not mandatory.

Continued efforts at standardization, the prudential incentive to extend clearing and the definition of clearing rules are at the heart of the debates, which will take place within the context of directives on capital requirements for market infrastructures.

Priority must be given to credit derivative markets, for which French banks propose two areas of reform:

- **A prudential incentive to harmonize contracts and centralized clearing via preferential capital treatment of derivatives cleared on CCPs (rather than the implementation of punitive treatment of derivatives cleared bilaterally).**
- **Implementation of central clearing counterparties supervised by the central bank issuing the currency in which the derivatives are denominated.**

## DETAILED ANALYSIS

### 1 General comments on the positive or negative impact of the MiFID directive

As mentioned in the introduction, the assessment of mechanisms resulting from the MiFID directive is necessarily limited to stock markets.

Given its general philosophy of creating competition for the markets, the directive implied four risks related to stock market operation:

- Applied to a market that cannot be extended indefinitely, it implied the risk of fragmentation and therefore a loss of liquidity.
- Based on the implementation of costly technological infrastructures and clearing and settlement systems that are not necessarily harmonized, it implied the risk of a sharp increase in indirect trading costs for intermediaries and encouraged the creation of dedicated trading systems, in some ways resembling London's old "jobbers" system, by large investment banks.
- Founded on the paradigm of interoperability, it implied the risk of failure to unify systems.
- European regulators have never wanted to take responsibility for data-centralization initiatives.

These four risks have tended to materialize, and issuers and some investors have very critical opinions of the directive.

That being said, regarding the positive aspects of the MiFID directive's implementation it should be noted that there has been a decrease in direct unit trade costs,<sup>1</sup> as well as the emergence of new service offerings aimed at better satisfying investor requirements. In addition, the directive has created conditions for harmonizing (though not perfectly) the terms under which intermediation activities are carried out in Europe.

From the standpoint of investor-protection rules, the main remark concerns the complexity of implementing certain principles:

- Operational complexity regarding new client segmentation, and the various directives' lack of harmonization in terms of investor definitions, i.e. qualified investors (Prospectus Directive) and professional clients (MiFID).
- Unresolved questions regarding enforcement of the rules of conduct applicable to cross-border activities carried out by branches.
- Negative effects regarding the inducement transparency mechanism in terms of the relationship with institutional clients, insofar as French banks are in competition with US and Asian players not subject to the mechanism.

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<sup>1</sup> Offset by the growing number of trades needed to execute the same number of securities, which ultimately results in an increase in costs actually incurred.

## 2. Analysis of the MiFID directive's impact on equity market efficiency

*Three aspects merit discussion:*

- *Competition among lit venues (regulated markets, MTFs).*
- *Competition between lit venues and opaque markets (crossing networks and dark pools).*
- *Conditions of competition among intermediaries.*

*French banks believe that:*

- *Given the role played by arbitrageurs, a study on high-frequency trading could be effectively carried out regarding the appropriateness of European time tick-size harmonization.*
- *Opaque venues (crossing networks, dark pools) can improve execution conditions, but potentially create competitive distortions. Therefore, with the exception of block trades (to be defined), all orders going through these venues must be subject to pre-trade transparency.*
- *Potential abuses relating to flash orders must be corrected.*

### 2.1. Competition among lit venues (regulated markets, MTFs)

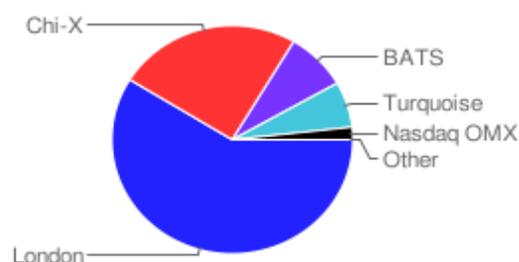
The MiFID directive called for the implementation of two types of competition system on regulated markets: MTFs (multilateral trading facilities) and systematic internalization.

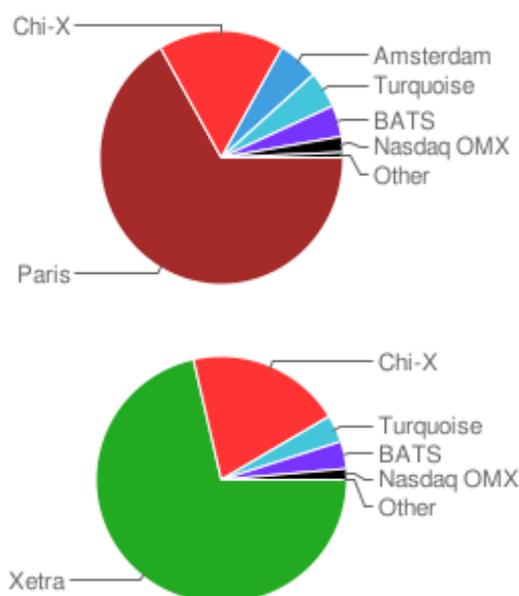
**Two observations should be made:**

- **Systematic internalization is used only marginally.**
- **MTFs now have significant though minority market share.**

The main effect of the directive has been the emergence of several **multilateral trading facilities**, the four largest of which today represent between one-quarter and one-third of trades completed on traditional regulated markets, as shown in the graph below.

Market share of MTFs in the three leading European indices (FTSE 250, CAC 40 and DAX 30), first week of November 2009





**TABLE 1  
POST-TRADE INFORMATION ON THE EUROSTOXX 600  
(September 2009 in €)**

| EXCHANGE VENUE          | TURNOVER        | % SHARE | EXCHANGE VENUE   | TURNOVER                 | % SHARE        |
|-------------------------|-----------------|---------|------------------|--------------------------|----------------|
| Markit BOAT - OTC       | 240,046,471,210 | 21.19%  | SWX              | 1,110,175,879            | 0.10%          |
| LSE Group               | 206,432,619,778 | 18.22%  | Burgundy         | 1,106,039,272            | 0.10%          |
| Euronext                | 130,665,950,443 | 11.53%  | CHI-X - OTC      | 1,082,204,794            | 0.10%          |
| Euronext - OTC          | 117,692,420,465 | 10.39%  | POSIT            | 785,205,788              | 0.07%          |
| CHI-X                   | 81,451,906,995  | 7.19%   | TLX              | 763,473,123              | 0.07%          |
| Deutsche Boerse         | 80,870,907,644  | 7.14%   | Stuttgart        | 547,017,684              | 0.05%          |
| Spanish exchanges       | 57,464,149,294  | 5.07%   | NYFIX            | 503,653,009              | 0.04%          |
| Nasdaq OMX Nordic       | 44,547,818,641  | 3.93%   | Vienna - OTC     | 241,599,233              | 0.02%          |
| SWX Europe              | 40,592,531,883  | 3.58%   | Prague           | 182,997,307              | 0.02%          |
| LSE Group - OTC         | 27,545,165,521  | 2.43%   | SWX - OTC        | 157,320,244              | 0.01%          |
| Turquoise               | 25,541,950,944  | 2.25%   | Munich           | 83,899,838               | 0.01%          |
| BATS Europe             | 21,579,818,126  | 1.90%   | Hamburg          | 83,617,321               | 0.01%          |
| Deutsche Boerse - OTC   | 15,387,528,817  | 1.36%   | NYSE Arca Europe | 64,613,303               | 0.01%          |
| Oslo                    | 11,910,793,160  | 1.05%   | Dusseldorf       | 61,161,066               | 0.01%          |
| Nasdaq OMX Europe       | 4,274,745,183   | 0.38%   | Warsaw           | 34,529,238               | 0.00%          |
| Athens                  | 4,014,094,509   | 0.35%   | Berlin           | 22,812,275               | 0.00%          |
| Irish SE                | 3,739,772,775   | 0.33%   | Oslo - OTC       | 20,997,558               | 0.00%          |
| Vienna                  | 2,693,309,303   | 0.24%   | Hanover          | 16,142,937               | 0.00%          |
| Liquidnet               | 2,244,313,778   | 0.20%   | Bucharest        | 4,716,741                | 0.00%          |
| Nasdaq OMX Nordic - OTC | 2,018,740,363   | 0.18%   | Luxembourg       | 3,939,734                | 0.00%          |
| Plus Markets            | 1,990,198,214   | 0.18%   | Reuters - OTC    | 699,279                  | 0.00%          |
| SWX Europe - OTC        | 1,680,310,799   | 0.15%   | Equiduct         | 439,024                  | 0.00%          |
| Stuttgart - OTC         | 1,673,306,757   | 0.15%   |                  |                          |                |
| Source: Thomson Reuters |                 |         | <b>Total</b>     | <b>1,132,936,079,249</b> | <b>100.00%</b> |

Since MTFs are subject to the same pre-trade transparency obligations as regulated markets, their emergence has not significantly impacted the price-formation mechanism *per se*.

However, the competitive methods used by MTFs and regulated markets have profoundly changed the structure of order books and therefore affected price-formation mechanisms. In particular:

- **A sharp decrease in tick sizes** (i.e. the minimum time variation between two consecutive prices) has helped reduce the bid/ask spread. Quantities available at the best limit are lower, but this has not contributed to a decrease in execution quality; it has also facilitated arbitrage of the orders placed (introduction of a best-bid order costing only the reduced tick size). Fragmentation has not been shown to have a negative effect on price formation, and a study by the CFA shows that spreads have even decreased.
- **The introduction of different pricing models for liquidity providers and takers** (so-called "maker-taker" models), as well as the decrease in latency (i.e. information time for accessing market data, which is currently calculated in milliseconds, and placing orders), mainly *via co-location models* (which for market members involves locating access tools as close as possible to the order book), have attracted order flows from statistical arbitrageurs.

**Given the role played by arbitrageurs, who act on their own account, a study could be effectively carried out on the appropriateness of European tick-size harmonization.**

## **2.2 Competition between lit venues and opaque markets (crossing networks and dark pools)**

**It has been noted that opaque venues (crossing networks, dark pools) can improve execution conditions, but have the potential to create competitive distortions.**

During the market-computerization process, small orders used in price formation were moved quickly to order books. Larger orders, however, could not be processed with the same efficiency. Dark pools and crossing networks are innovations to bridge this gap in matching mechanisms and should be encouraged.

However, two recent developments give cause for concern:

- The shift from a block trading system to small orders (which already represent 70%<sup>1</sup> of dark volumes in the USA).
- The capture of this liquidity by private networks and operators, which operate opaquely in terms of access conditions, prices and/or reporting of trades.

This phenomenon can therefore have an adverse effect on both the price-formation mechanism (since such small orders are typically those involved in the open market dynamic) and fair access to liquidity for all players, particularly the smallest.

French banks are therefore of the opinion that, with the exception of block trades (to be defined), all orders going through dark pools should be subject to pre-trade transparency.

## **CROSSING NETWORKS**

The **crossing networks** created by intermediaries have only attained (and structurally cannot exceed)<sup>2</sup> a marginal market share (less than 5%), and therefore have no material impact on the price-formation mechanism. In addition, these systems offer innovative solutions that are well-liked by institutional investors, in that they allow the "average of spreads" execution seen on regulated markets while also limiting orders' exposure to the arbitrage mechanisms used on regulated markets and MTFs (see above), such as dark pools.

In this respect, we should emphasize that crossing networks involve the discretionary treatment of client orders by brokers, which is a much different service than that offered by the markets and MTFs (nondiscretionary matching of members' orders). Moreover, the absence of pre-trade transparency for crossing networks simply reflects this fundamental difference. In fact, the search for opposing interests aimed at completing off-book trades has always represented a key role of brokers and an essential component of the value-added expected of them by investors.

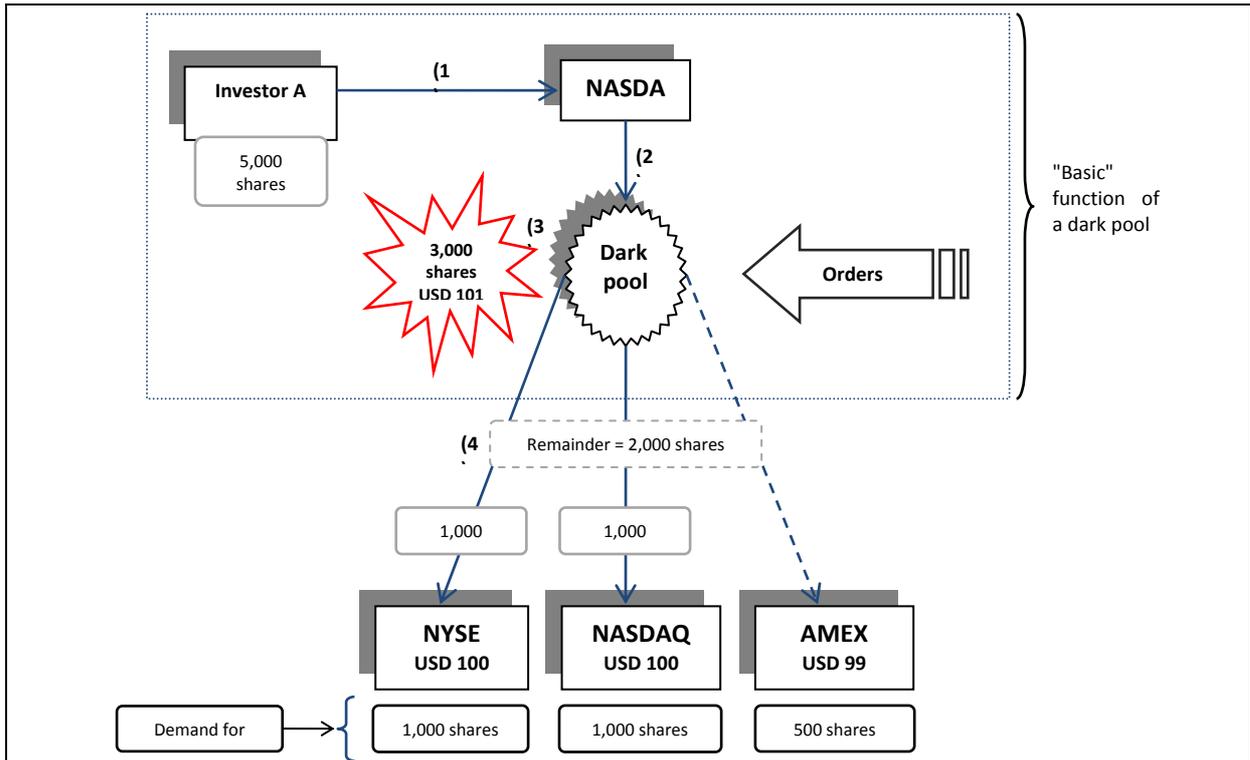
## **DARK POOLS**

**Dark pools** are stock trading venues that serve as an alternative to regulated markets. They allow investors to place large orders anonymously and without pre-trade transparency and with little impact on the prices of regulated markets. They are generally owned by large investment banks or stock exchanges.

### **Order placement on a dark pool**

- Placing a large order can pose problems for the investor (market impact and imitation phenomenon). These problems can be avoided by using a dark pool, since neither the order book nor the investor's identity are accessible.
- Given that order characteristics are not made public (prices are displayed only at the end of the trade), dark pools allow institutional investors to place orders without impacting the price of regulated markets. In fact, they are not subject to the pre-trade transparency requirements imposed on regulated markets and most multilateral trading systems to provide bid and ask prices continuously during normal trading hours.
- *Example: Rather than trade on a regulated market, investor A wishes to take advantage of the liquidity offered by a dark pool. A's order (5,000 shares sold for USD 100) is processed as follows (see illustration below):*
  - (1) To transmit his order to a dark pool, the investor must go through a centralized market or broker-dealer. For example, he can go to NASDAQ, which has a dark pool;
  - (2) NASDAQ transmits the order to its dark pool;
  - (3) The dark pool automatically matches the order with buy orders in the dark pool.<sup>3</sup> Once the order is executed, it is confirmed that the dark pool was able to sell 3,000 of the 5,000 shares at USD 101 per share;
  - (4) The dark pools can then automatically sell the remaining 2,000 shares on regulated markets to complete the order. In this example, the demand for shares on the NYSE (1,000 shares at USD 100) and NASDAQ (*idem*) allow the order to be fully executed at the price requested by A. The offer at USD 99 proposed by AMEX is not accepted.

<sup>2</sup> Since they are accessible only to the orders of the broker in question.



**Dark pool activity has grown significantly in recent years**

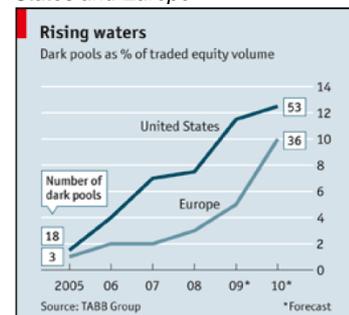
Following creation of the Liquidnet dark pool in 2001, the number of dark pools has continued to increase:

- With traditional stock exchanges processing more and more small orders,<sup>4</sup> dark pools have become preferred systems for processing block trades.
- The dark pools created have eaten into the market share of large stock exchanges.<sup>5</sup> These exchanges have responded by launching their own dark pools.

**In the United States**, more than 40 dark pools are active, and their activity is estimated at **9% of all shares traded**.

- **In Europe:**
  - Prior to the MiFID directive's implementation, the order-concentration rule stipulated in the Investment Services Directive (ISD 93/22/EEC) limited competition in the stock-trading sector. This rule involved all trades being completed on a European regulated market (in practice, generally that of the country in question), despite the fact that solutions for processing trades off the order book already existed.
  - The MiFID directive changed this situation by eliminating the order-concentration rule and creating competition between regulated markets and other trading channels.

Dark-pool activity growth in the United States and Europe



<sup>3</sup> This matching generally occurs based on a price imported from the reference market.

<sup>4</sup> As a result of the use of algorithm-based electronic trading, computer systems break down orders into several smaller orders and assign them to various venues in order to benefit from better execution conditions.

<sup>5</sup> In April 2001, at the time of Liquidnet's launch, one of the largest banking dark pools (including J.P. Morgan), block trades of 10,000 shares or more accounted for 60% of NYSE activity, but by the end of 2007 these trades accounted for only 18% of NYSE orders.

<sup>6</sup> In addition to the dark pools mentioned in footnote 6, the following European MTFs have their own dark pools: Chi-X, Turquoise, NASDAQ OMX Europe and BATS Europe. POSIT is a "pure" European dark pool.

- A dozen or so dark pools have thus already been created in Europe.<sup>6</sup>
- Of 30 billion Euros in shares traded daily in Europe, 7-10 billion Euros is thought to be available via dark pools.
- In total, dark pools are believed to attract approximately 1/10th of worldwide stock liquidity (source: TABB Group).

**Dark pools improve market liquidity and efficiency**

- For some, the use of dark pools is based on the principle of best execution, which for an intermediary involves taking all reasonable measures to offer the client the best possible result when executing orders:
  - Dark pools allow for the placing of huge orders at a cost generally lower than that charged by a traditional stock exchange.
  - The possibility of routing orders to dark pools improves market liquidity and efficiency while having a minimal impact on prices.

**However, opacity and a lack of control over dark pools' activities pose risks**

- For investors, the growing number of dark pools could lead to a rise in fragmentation, thereby causing these venues to lose their advantage.
- For regulators, dark pools pose several problems, since they have the potential to adversely affect investor protection and market integrity:
  - They are not subject to pre-trade transparency rules.
  - They interfere with the normal price-formation process due to their opacity.
  - Those with access to dark pools have an advantage over the rest of the market, thus creating a “two-speed” system. The argument whereby dark pools encourage the fulfilment of best-execution obligations, insofar as the client's order is not subject to market impact, really amounts to favouring the interests of some clients at the expense of overall market efficiency.

### **2.3 Competitive conditions among intermediaries**

- **Competition that facilitates the work of arbitrageurs...**

Competition implies that the same rules apply to all competitors. The issue of indirect costs as related to the growing number of venues encourages a concentration of intermediaries, which must have sufficient financial resources to assume these costs; this is a normal condition of competition.

Competition among the various venues has led to a destructuring of the market, which has resulted in a tick war (minimum upward or downward change in share prices) and the emergence of a new category of player supported by the pricing implemented by regulated markets.

The most obvious means available to MTFs for attracting order flows at the start of their activity was to offer lower tick sizes than the primary markets. This enabled arbitrageurs to position themselves within the spread in order to try to capture part of it.

The development of SORs (Smart Order Routers) and their widespread use therefore ensured that an arbitrageur situated just within the spread would be executed automatically as soon as a limit order was sent via an SOR.

One of the factors that limited the flexibility of primary markets was also linked to the inability of some large networks to handle orders beyond the second decimal place. It took nearly two years for the war to end and for market players to agree on a common table. In the meantime, the average tick size was divided by 10, and volumes within spreads were reduced significantly due to this division.

### ***...and rewards liquidity provision***

Another means available to MTFs for attracting order flows involved attracting "market-makers" through differentiated pricing for makers-takers, as they are a key vector for the transit of orders from one market to another and thus for generating trades through liquidity provision.

All of the pricing implemented has therefore been structured to favour volume and liquidity. Order additions and modifications, which were originally billed, are now free. MTFs have all used the same maker-taker model, in which a passive order or liquidity provider (which is placed on the market but not executed immediately) is remunerated, and a limit order or liquidity taker (which crosses the spread for immediate execution) is billed.

Some markets have even gone so far as to implement differentiated pricing, whereby principal orders have preferential pricing in relation to client orders. Agreements have also been signed with liquidity providers to try to continuously offer shares at the spread levels offered by other markets. This policy, originally implemented by the MTFs and based on their maker-taker model, has been adopted by primary markets in an effort to defend their competitive positioning.

The differentiated pricing models thus implemented have attracted order flows from arbitrageurs wishing to reap the reward of the risk-taking and liquidity provision that results from passive orders, in effect contributing to the markets' smooth operation and greater competitive strength.

#### **▪ An increase in indirect costs...**

Intermediaries have not benefited from the decrease in trading costs, given that indirect costs, which they have assumed rather than pass on to investors, have largely increased.<sup>7</sup> Intermediaries have had to make major investments in fixed costs.

First of all, market trading processes had to be automated. It is in fact impossible to efficiently access all venues without having an SOR and electronic connections with all markets. Moreover, the speed at which the markets move also requires the processing of a maximum number of trades using trading algorithms and automated systems. Complex systems for verifying and monitoring execution quality - TCA (Transaction Cost Analysis) - have also had to be implemented. These costs have represented a significant portion of the investments made by intermediaries over the past two years.

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<sup>7</sup> For investors, costs are approximately the same as they were before the MiFID directive.

Changes in the markets' microstructure resulting from this computerization and the various arbitrage, inter-market and high-frequency activities have resulted in average trade size dropping by two-thirds in two years (from 25,000 euros to 7,000).

The consequent increase in indirect costs has not been offset by the decline in market and clearinghouse prices. (With regard to clearing, it should be noted that the growing number of MTFs has led to the emergence of new CCPs and therefore an overall increase in indirect clearing costs.)

### **...and the flash-order problem (seen mostly on US markets)**

Flash orders are those made visible to some or all market members by a centralized market prior to their official central order-book entry in order to preserve the market's liquidity and increase its attractiveness.

To take advantage of the opportunities offered by this type of order, investors must react much more quickly (in milliseconds and even microseconds) than market operators. Only large investors involved in high-frequency trading and thus possessed of computerized, automated trading systems have the means to react and take advantage of flash orders.

Although in theory these orders improve the efficiency of centralized markets, they create unequal treatment among market participants.

Flash orders have been used for several years. The Chicago Board Options Exchange (CBOE) was the first venue to use them in an attempt to improve execution speed. This activity remained limited until June 2006, when several players, such as Direct Edge, began to specialize in this area. In June 2009, flash orders accounted for approximately 2.4% of all orders executed in the United States.

Defenders of this practice believe that such information transmission helps to improve:

- *Market efficiency*: the percentage of orders processed by Direct Edge thus rose from 1% to 12% of all orders placed on the market between June 2006 and June 2009.
- *Market liquidity*: for example, flash orders allow some small participants to find liquidity more easily and quickly.

Conversely, detractors believe that they cause unequal investor treatment in terms of access to market information.

### **3. Analysis of the MiFID directive's impact on investor protection**

The MiFID directive has not fundamentally changed working methods, since the principles of loyalty and the obligation to act in the best interests of the client already existed, even if they were applied less consistently.

However, the directive has resulted in greater traceability of the steps completed, as well as increased procedural formalization, more stringent controls and more uniform practices, particularly in terms of best execution.

The MiFID directive has also led to a review of compensation rules for networks' commercial agents by putting an end to the determination of variable compensation based

on the products distributed (according to their type), a factor that could result in suspected conflict of interest.

## **Inducements**

Under the auspices of the French association of credit institutions and investment firms (AFECEI), French establishments have developed professional best practices regarding the publication of inducements related to UCITS direct distribution, thereby enabling clients to compare commissions paid and received. These best practices have been approved by the French financial-market authority (AMF), and their implementation will be monitored by the AMF and the Banking Commission.

## **Client segmentation**

As mentioned in the introduction, the new client segmentation has resulted in operational complexities, mainly due to large corporate investors' ability to declare themselves as individual investors.

In fact, the following paradox has been noted: large corporate investors choose to be categorized as individual clients while routinely refusing to undertake the formalities involved in such a classification, like questionnaire completion.

## **Best execution**

The principle of best execution gives rise to two types of problem:

- The first, an intrinsic one, is tied to the fact that all responsibility lies with the intermediaries, while the venues have no similar liability whatsoever. A study on extending the principle to trading venues could be undertaken.
- The second is related to client segmentation, which encourages investors that should be considered professional investors by their nature to downgrade their classification.

It is therefore the scope of the principle (Who should guarantee best execution? Who should benefit from this guarantee?), rather than the principle itself that poses a problem.

## **4. Analysis of the MiFID directive's impact on competition among infrastructures**

### **Stock markets**

With regard to **market infrastructures**, it is premature to pass judgement since not all alternatives to regulated markets, which were created after the MiFID directive took effect, show signs of long-term profitability (particularly the MTFs). However, legislative conditions regarding competition among these players are satisfactory, provided that large orders (blocks), which are the only orders not subject to transparency, are properly defined. Otherwise, there is the risk that dark pools might attract all large orders, while only small orders and arbitrageurs' principal orders will be left to transparent venues.

With regard to **post-trade infrastructures** (clearinghouses and central depositories), several points are worth noting:

- In terms of longstanding infrastructures, attempts to develop interoperability have failed thus far.
- At present, seven clearinghouses<sup>8</sup> share - mostly via local monopoly relationships with execution venues - a European market that is two times smaller than the US market, which is fully cleared via the DTCC infrastructure.
- Market security, and therefore investor confidence, depends in large part on the ability of post-trade infrastructures to intervene in case of intermediary or investor failure and to prevent a special risk from becoming systemic.

Under these conditions, it would be especially harmful if competition prevailed among post-trade infrastructures in terms of security levels provided to participants (via less stringent margin-deposit and margin-call mechanisms).

**It is also necessary - as the French banking industry has always argued - that clearing and settlement have a clear pan-European legal basis and that the concentration of post-trade infrastructures should be encouraged.**

## **Derivatives markets**

The economic crisis has highlighted the need for a clear post-trade legal basis in light of the systemic risk problem caused by the CDS markets, on which standardization of contracts and clearing and the intervention of central clearing counterparties are essential.

In this regard, French banks have noted that the effectiveness of systemic risk prevention via implementation of central clearing counterparties assumes that the latter are able to draw on central-bank liquidity within a given day in case of a key market player's failure (see appendix).

In this respect, clearinghouses and central banks demonstrated their ability to respond quickly and effectively when Lehman Brothers failed.

However, this implies that the central clearing counterparty is overseen by a central bank that issues the currency in which the cleared instruments are denominated (i.e. in the euro zone for credit derivatives denominated in Euros).

Standardization and centralized clearing should not be mandatory, but rather incentive-based (through favourable prudential treatment in the CRD).

Moreover, in order to avoid both the concentration of systemic risk and the development of monopolies harmful to competition, French banks have always been opposed to the creation of "silos," i.e. organizations that combine market, clearing and delivery-versus-payment infrastructures. Strict separation within different organizations is crucial.

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<sup>8</sup> LCH-Clearnet for Euronext and the London Stock Exchange, Eurex Clearing for Deutsche Boerse, CCP Austria GMBH for the Vienna stock exchange, Cassa di Compensazione e Garanzia S.p.A. for the Italian market, X-Clear for the Swiss market, EMCF for Chi-X and the Scandinavian markets and Euro-CCP for Turquoise.

## 5. Bond markets

For bond markets, the question is not one of competition among intermediaries or infrastructures, but rather of pooling: the focus must be on bolstering the secondary market's liquidity.

What French banks support is thus not an extension of the rules applicable to stock markets, but the creation of rules specific to bond markets.

These rules are necessary in terms of **post-trade transparency**, based on the following:

- Definition of thresholds by market type (corporate or government bonds), above which there would be no reporting.
- Definition of the post-transaction declaration period (end of the day for all that day's transactions, for instance).
- Data centralization, in order to facilitate access by all players.

The necessary information must be provided to players in order for buyer and seller interests to be matched on the secondary market. Several basic points are worth mentioning here:

- Structurally, bond markets are primary markets and there is significant liquidity only during the 30 days following the issue.<sup>9</sup> Most investors then choose to hold securities until maturity ("buy and hold"), because of the different nature of stocks and bonds: stocks have no maturity and there is no specific guarantee of any gain, while bonds have a predefined yield and maturity. Moreover, investors may wish to enter and leave the stock market at any time, whereas they are inclined to hold bonds until maturity.
- There is no bond market for individual investors in France.

It must also be clear that the secondary market's liquidity will, by its very nature, always be marginal.

That being said, post-trade transparency is important, and the directive must establish guiding principles for such transparency.

With regard to secondary-market liquidity, the French industry has already made several proposals. Indeed, French banks believe that, given the special nature of these markets, the banks' voluntary commitment will be effective, where legislation would run the serious risk of dissuading players from stimulating this market.

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<sup>9</sup> Of the 200,000 bonds listed in Europe, less than 10% are "liquid," and we speak of limited liquidity.

## ANNEX

### FRENCH BANKING FEDERATION'S POSITION ON THE IMPLEMENTATION OF CENTRAL CLEARING COUNTERPARTIES FOR CREDIT DERIVATIVES

#### THE ACCESS OF CENTRAL COUNTERPARTIES TO LIQUIDITY

#### I/ Access to liquidity in central bank money enables CCPs to perform in an efficient way the management of the default of a member:

##### 1) CCPs liquidity needs under normal circumstances or during the management of a default:

- CCPs liquidity needs under normal circumstances: the normal operation of a CCP may generate liquidity needs during the day which are related to the different functions of the CCP, i.e. its settlement function (as clearing house) or its guarantee function (as central counterparty).
- CCPs liquidity needs during the management of a default: this situation generates substantial additional liquidity needs for the CCP whatever its specialisation in terms of products (cash or derivatives products).
  - The issue of the default of a clearing member is more commonly envisaged in terms of credit and market risk management than in terms of liquidity risk. However, the experience of the default of a major financial institution like Lehman Brothers has demonstrated that the CCPs can be put under a strong liquidity pressure when managing a default and then that the access of CCPs to liquidity is a key factor for the efficiency of the default management function performed by CCPs. After the default of a clearing member, the CCP substitutes the defaulter to perform the obligations stemming from the outstanding trades in the defaulter's portfolio, which have been accepted in the clearing system. Therefore, the CCP has to "carry" the defaulter's positions until they are finally liquidated and the CCPs has performed all defaulter's obligations, including cash settlement. This is  
The source of CCPs' additional liquidity needs which can not be entirely fulfilled with the collateral posted to cover the defaulter's positions.
  - Liquidity problems may also be triggered by the default of a depository bank used as depository for its collateral. The liquidity coming from the margins and the default funds is normally deposited with some banks which must present a very low credit risk. Even though CCPs guarantees are legally protected and segregated in the accounts of the defaulter, the collateral of the CCP held with this depository bank could be blocked due to possible legal dispute or delays caused by the insolvency procedure launched against the depository bank. The CCP would have then to fulfil an unexpected liquidity gap owing to the unavailability of this collateral.

**2) the respective efficiency of CCPs access to liquidity in central bank money and in commercial bank money:**

- the commercial settlement banks granting credit lines to a CCP can be themselves under strong liquidity pressure during the management of default, and therefore not in a position to provide the needed liquidity to the CCP ;
- the implementation of T2-S and CCBM2 will increase the advantages of using central bank money by optimising liquidity and collateral management.

CCPs need to make money settlements with their participants for a variety of purposes, including the collection and payment of cash used to meet margin requirements. Two basic models are identified: a central bank model and a private settlement bank model.

- In the central bank model, the central bank of issue (of the currency in which the payments are being made) is the sole settlement bank used by a CCP, and all money settlements between a CCP and its participants are effected in central bank money. A CCP's participants may have accounts with the central bank or may effect settlements with the CCP through banks with accounts at the central bank (a tiered settlement arrangement).
- In the private settlement bank model a CCP selects a group of private banks as its settlement banks establishes an account with each of these settlement banks and requires each of its participants to establish an account with one of them. Money settlements between a CCP and its participants are effected in private bank money through their accounts at the settlement banks. To the extent necessary, a CCP's accounts at the settlement banks can then be balanced by transfers between the settlement banks, which typically are effected in central bank money through the national payment system.

The commercial bank model has a number of drawbacks :

- use of the private settlement bank model exposes a CCP to the risk of a settlement bank's failure (the commercial bank model could face very challenging issues to handle the default of a major participant). In a situation of distress interbank market, the pool of settlement banks, although committed by credit lines with the CCP may simply not be able to provide timely a sufficient amount of liquidity in order to meet the CCPs liquidity needs in relation with the liquidation of the positions of the defaulter.
- moreover, there are no (public) rules on the eligibility of the collateral, i.e. the commercial banks acting as settlement banks are free to set up their own collateral rules that they apply when extending credit to the CCP. A private settlement bank may thus accept collateral that is less liquid and of lower quality than the collateral accepted by the Eurosystem. If so, the CCP would have incentives to hold such low-quality collateral, in particular as the cost of holding low-quality collateral is lower than that of holding high-quality collateral. As a result, the CCP's balance sheet would contain more low quality collateral, which would diminish the overall financial soundness of the CCP.

- another disadvantage is related to behavioural problems that may occur in the event of a CCP's default: if the overall amount of collateral that the CCP has posted with the settlement bank exceeds that bank's claims against the CCP, then the settlement bank may choose the collateral that it prefers to cover any open positions. The settlement bank is likely to choose "good" collateral, i.e. cash collateral and other types of liquid and good-quality collateral leaving other creditors with collateral of less quality. In the central bank model where the Eurosystem collateral eligibility criteria would apply, such distortions among different types of creditors would not exist.

The central bank model has a number of advantages. In particular, use of the central bank model eliminates a CCP's settlement bank risks. Moreover, the CCP has easy access to a potentially large amount of liquidity given the Eurosystem's broad range of eligible collateral.

## **II/ Access to Eurosystem's credit operations: the need to guarantee its adequate oversight over the entities accessing to central bank liquidity**

The strong link between the location of the infrastructure and its possibility to central bank operations is supported by the following considerations:

- the Eurosystem needs to be in a position to have effective oversight competences on the CCP opening an account in its books (the direct oversight of the central bank on its counterparties is indeed a mean to mitigate the moral hazard inherent to the credit activity of central banks) ;
- the direct access of the overseer to the infrastructures allows mitigating the risk that a CCP overseen by another central bank would take on excessive risks being subject to less stringent rules. This link between central bank's oversight competence and the ability to open an account in its books is not a specificity of the Eurosystem but is a common policy of central banks (for instance, FED's rules for the opening of an account include a similar condition).