15 December 2011

Ref. 2011/1962

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Proposal for a directive on financial instruments markets by the European Commission

The proposal by the European Commission is comprehensive and complicated. It concerns instruments and markets that are not within the mandate of the Debt Office and with respect to which the Debt Office is not knowledgeable. We have therefore opted to concentrate our comments on issues that concern trading of interest-bearing securities, particularly the proposed rules regarding transparency of the trading.

We start our response by presenting some background information, thereby offering a few comprehensive opinions as regards the proposal's points of departure and direction. Afterwards, we discuss, firstly, the weak link between MiFID as a directive for the protection of investors and the proposal to apply MiFID rules to the fixed income market. Secondly, we review the way in which the rules have been formulated with respect to the transparency of trading in interest-bearing securities in the draft EU regulation. By way of conclusion, we explain how an application of MiFID rules without careful consideration would have a detrimental impact on trading interest-bearing securities, thereby increasing the government's cost of financing the central government debt.

By way of summary, we consider it most doubtful that there exists sufficient reason to include trading of government securities in the MiFID regulations. This is a market where only professional actors are currently active and these actors must be assumed to be able to exercise their duties without specific investor protection in place. If such measures were nonetheless to be implemented, it is important that professional trading activity be exempted from extensive requirements with respect to transparency. Otherwise, the conditions for activity in these markets would be negatively impacted, which would have a detrimental effect on market liquidity and increase the state's funding costs. An exemption from the regulatory requirement should be designed by setting a limit amount for immediate reporting that is low enough that transactions between professional actors are automatically rendered exempt. If this is done using clearly-worded language in the directive, the Debt Office's concern that the rules stipulating post-trade transparency would have a detrimental effect on the Swedish fixed income market are alleviated.

We also oppose the proposal to include the rules on transparency in an EU regulation. Such rules should remain contained in one cohesive directive. The right to draw up necessary rules should instead be delegated to national regulatory bodies. The issues at hand are too complex to be effectively handled through common policies at EU level. The principle of subsidiarity should therefore be taken into account in continued discussions of the current matter.

The Commission's proposal aims to change complex market mechanisms. This is being done without a clear analysis of the shortcomings of these mechanisms or a basic insight into how these mechanisms function. There are therefore compelling reasons for Sweden to argue for fundamental amendments to the draft regulations before they enter into force.

The arguments for regulation

For a number of years now, the point of departure for legislative work in the financial sector has been that, in order to justify the drawing up of sectorial rules, there must be an identified market failure, as well as a well-reasoned assessment that this problem can be effectively addressed through state intervention. This view has been particularly well-represented within discussions in Sweden, but has also served as the guiding principle at the EU level. One example is that one reason for the first version of the MiFID concerning only trading in shares was that it was considered that there was no market failure regarding trading in interest-bearing securities. One reason for this was that this market is completely dominated by professional actors. Given that the MiFID already grants exceptions for professional investors, there was no reason to apply the directive's rules to trade in interest-bearing securities.

The aim of the new regulatory proposal is different. Certainly, there remains the main intention to increase the protection of investors and to promote the internal market for financial services (see reason 3 in the preamble). But to this has been added reason 4:

> The financial crisis has exposed weaknesses in the functioning and in the transparency of financial markets. The evolution of financial market has exposed the need to strengthen the framework for the regulation of markets in financial instrument in order to increase transparency, better protect investors, reinforce confidence, reduce unregulated areas, ensure that supervisors are granted adequate powers to fulfil their tasks.

This point of departure can be discussed on several levels. First, it is a fact that the crisis was concentrated within the most stringently regulated parts of the financial system, i.e. the banks. As such, it is not self-evident that the financial crisis can be used as an argument for the need for increased regulation of other markets where similar problems have not been observed.

Second, the link between the crisis and how trading on securities markets is organised has not been particularly well elucidated. This argument is often used to open up for new regulatory measures. This is problematical. Let us examine one example. One aspect responsible for the crisis spreading was that the banks' access to regular financing markets was cut off. At this stage, liquid government securities markets constituted a completely decisive means for them to stay afloat. Given this, it would certainly be conceivable that concern for liquidity in, for example, government securities markets would be given high priority. However, this sort of reasoning is not at all represented in the proposal. As a result, potential effects on market liquidity are not clearly and comprehensively taken into account, which could have serious consequences; see below.

However, the most notable in this context is that an indicated goal is to "reduce unregulated areas". This can hardly be interpreted otherwise than that the underpinning has shifted and that market failure is no longer a necessary precondition. Rather, the goal of addressing "regulatory holes" – meaning, markets that have remained unregulated – has become the focus.

The Commission's premise thus seems to be that private actors are not capable of organising well-functioning markets, but that this is something that only the EU Commission and various other regulatory bodies can handle. Based on this highly dubious point of departure, it is only logical to propose that regulatory authorities should take on the responsibility also for markets that only involve professional actors.

The specific issue at hand in this context is if it actually is reasonable to change MiFID from being a tool for investor compensation on the equity market to a general tool for intervention with respect to how trading in financial instruments of any type is organised. And the even more prominent issue concerns whether the complex coordination problem that arises in connection with the organisation of the financial market is best handled by politically-appointed committees.

The Debt Office refrains from attempting to analyse this larger question within the scope of this response. We can, however, establish – for the reasons developed below – that as an example of how the committee approach functions, the Commission's proposal for new regulatory mechanisms for trade in financial instruments gives cause for concern. The proposal does not give the impression of the Commission having understood the complex relationship which it is now intending to regulate. It is therefore highly uncertain whether the proposed regulations would be compatible with continued – and this meant literally – well-functioning trading of interest in securities in Sweden.

MiFID as an investor protection framework

The handling of transparency rules must be seen in the light of existing needs for protection. A central point of departure must then be that non-professional (retail) investors have a greater need for protection than professional investors. This is indicated as a stated objective of the new regulatory framework, as indicated in reason 56 in the preamble to the new directive:

> One of the objectives of this directive is to protect investors. Measures to protect investors should be adapted to the particularities of each category of investors (retail, professional and counterparties). (...)

This text is the same as in the currently applicable directive. This is explained in the preparatory memorandum as follows: "The classification of clients in the directive on markets for financial instruments according to retail, professional and eligible counterparties offers a sufficient and satisfactory degree of flexibility and should therefore remain largely unchanged." (p. 8)

In application to the above, investment firms (according to Article 30) are not required to apply certain rules to actors classified as professional. Among these, there is the requirement of most favourable terms to the client (Article 27). Since the requirement on transparency is largely motivated by the aim of ensuring that investors obtain the best possible price, the exception stipulated in Article 30 must reasonably also have a bearing on how the transparency rules are drawn up.

Specifically, this should mean that transactions that are of such nature that they concern professional investors should be exempted from the requirement on transparency. An obvious criterion to be considered is therefore the size of the transaction. The prices involved in transactions that are only of relevance to professional investors provide no real informational value for determining whether a transaction involving a retail investor has been effected at the best possible price. This assessment must be based on the prices at which transactions of a comparable size were realized at the given point in time, not on what happened in a fundamentally different market segment. The notion that immediate reporting of volumes that are professionally traded would have any significance for smaller investors is even more unlikely.

This logic appears to have been guiding the CESR's (Committee of European Securities Regulators) earlier proposal that reporting requirements for trade in interest-bearing securities should concern limited amounts, e.g. that only transactions involving less than 1 million Euros should be subject to the requirement for immediate reporting. With this sort of arrangement, the concern of the Debt Office (and other debt managers) that transparency requirements would disrupt the professional segment of trade in interest-bearing securities, which is so important to the government, falls away.

The transparency rules in the proposed regulation

It is conceivable that the EU Commission has entertained similar ideas to those expressed above. The problem is that it is not clear from the draft regulation how these issues are supposed to be regulated. Instead, this is supposed to be taken up in delegated acts that the Commission will decide upon at a later stage. Neither the preparatory memorandum nor the text of the regulation says a great deal about how the legal acts that the Commission wants to be charged with drawing up are supposed to look. The text of the regulation is also unclear and is left open to numerous interpretations. This is highly unsatisfactory, in light of the consequences on trade in interest-bearing securities of poorly balanced decisions; see below.

By way of example, it appears as essentially possible for the Commission to take as their starting point the high flown ambition indicated in reason 9 in the preamble to the regulation:

> All organised trading should be conducted on regulated and be fully transparent both pre and post trade. Transparency requirements therefore need to apply to all types of trading venues, and to all financial instruments traded thereon.

This high level of ambition is admittedly modified in some of the paragraphs (for example, 12 and 14), where it is indicated that the requirement should take account of “the different characteristics and market structures of specific types of instruments”, that they “should be calibrated for different types of instruments, including equity, bonds, and derivatives, and for different types of trading, including order-book and quote-driven systems (....) and take account of issuance, transaction size and characteristics of national markets,” etc. However, more specific criteria for such differentiation remain unarticulated.

What is in effect a decisive policy issue for the Member States is thus delegated to the Commission to handle, at a level where basically only technical decisions should be taken. This is not acceptable.

One way to reduce the risk of serious consequences at the national level of Commission-promulgated regulations is to reject the proposal to introduce an EU regulation. Instead, rules on transparency – as in the current MiFID – should be placed in the directive. It is then logical that regulatory jurisdiction, via national law based on the regulation, is allocated to national regulatory bodies. Even in this case, there is reason to clarify the texts with respect to the bases on which exemptions from the general transparency rules can be granted, but this type of a solution effectively expands the room for adjusting the regulatory framework to specific circumstances in a given Member State. If it is to be possible in practice – and in accordance with reason 14 – to take account of the characteristics of a given national market, this would clearly offer a more reliable path upon which to proceed. Given that national considerations should be made, the argument for using an EU regulation as a regulatory means is also weakened, i.e. the principle of subsidiarity should apply to this discussion.

If, in negotiations, it proves impossible to change the model of an EU regulation, it becomes even more important to ensure that clear texts are introduced into the regulation as guidance for continued work with drawing up regulatory frameworks. As a first requirement, it is evident that reason 9 should be omitted or completely re-formulated, since the wording here is not in accordance with what follows.

Secondly, the requirement should be that texts must be added to the introduction and the actual body of the regulation, clearly guiding the Commission’s acts towards a reasonable balance between transparency and other concerns. The conclusion should therefore be that the requirement on transparency should be drawn up having regard to the conditions necessary for effective *professional* securities trading. It should moreover be made clearer on which bases the differentiation of requirements is done. It is not sufficient to, as at present, use the terms “types of instruments” without indicating how such a categorisation should be implemented.

For example, it should be clarified that "government securities" does not constitute a homogenous type of instrument. In this context, it is not possible to consider Swedish and German government securities as belonging to the same type of financial instrument. (It is not even reasonable to consider, for example, Finnish and Italian government securities, both in euro, as being part of a homogenous type of security in light of prevailing differences in terms of credit risk.) Consideration must therefore be taken to currency, market size, how trading is organised, etc. In a Swedish context, it is also necessary to make a distinction between nominal and real government bonds, in light of the conditions for trading for each of these being essentially quite different. Then, if one goes further to consider mortgage and corporate bonds, additional differentiation criteria should probably be added.

According to the Debt Office, the bases for differentiation stipulated in the draft proposal are entirely too unclear and difficult to interpret. According to Article 10, the responsible national authority can be given permission to defer publication of transactions in the light of "type or volume". In particular, it is provided that transactions that are "of a greater than normal scope on the market for the given security" can be exempted.

The "normal volume" of transactions is not, however, a good point of departure for making a differentiation as to whether the trading in question concerns professional or non-professional (retail) investors. Let's assume that only professional actors are active, which is the case in the majority of fixed income markets. Naturally, according to the wording of the regulation, the requirement on reporting should also apply to transactions that are "normal" in relation to the professional actors' trading patterns. This would mean that transactions lying, let's say, ten or twenty times higher than the limit envisioned by the CESR would need to be immediately reported. By definition, the intention to protect non-professional investors has long been forgotten and, instead, there has been an incursion into trading that only concerns actors who are not in need of the protection for which the MiFID was conceived. Nor is the fundamental property that a market maker trades against its own balance sheet considered. The capital that institutions must bind in order to handle even medium-sized orders would be subject to a risk in such way as to undermine the terms stipulated for this type of transaction; see below.

If the "normal volume" of a transaction is not a functioning criterion, it must be the content of the term "type" that is decisive. If this can be read as "transactions of a professional type", once again the door is opened to exempt these. But it is difficult to find anything in the text that clearly supports this interpretation. Reason 12 makes reference to "types of instruments" whereas Article 10(1) speaks of "types of transactions", which can hardly be the same thing. Article 10(2) indicates that the "type of security" should be taken into account when drawing up the terms for the granting of exemptions. The terms therefore slide back and forth. In light of the numerous aspects that can differentiate securities and the markets on which they are traded, a one-dimensional term such as "type" is far from satisfactory.

Notably, several paragraphs in the introduction discuss the issue of pre-trade transparency, including the circumstances in which the fundamental rules do not apply. There is no corresponding clarification with respect to post-transaction transparency. Even in the main body of the text in the regulation, the rules with respect to exemptions from post-trade reporting are shorter and more unclear. Indeed, this probably does not adequately respond to the importance of each of the issues at hand. As regards trade in interest-bearing securities, the information on screen on rates at which trading can be done is rather unproblematic, while information on volumes in completed transactions could prove to have deleterious consequences.

Without taking a position as to whether the terms stipulated for an exemption from pre-trade transparency have been reasonably drawn up, a feasible point of departure could be to require greater symmetry in the treatment of each of the relevant areas. The discussion that will be generated by the rewording of these texts can, in the best possible circumstances, be used to guide the regulation in the direction discussed above.

From the above argument, it is evident that the organisation of the trade in securities is in practice the result of a complicated relationship between a number of factors. That it should be possible for a committee decision at EU level to be able to take due account of this relationship in such way that the stated objective of "well-functioning markets" is actually achieved does not seem particularly probable. This speaks in favour of working with simple instruments that provide room for alternative solutions as regards aspects of trading in which investor protection is not relevant. The Debt Office would therefore like to recall the simple criterion that was initially discussed by the CESR, namely, a low-limit amount that clearly delimits the requirement on immediate reporting of transactions where only non-professional (retail) investors are involved.

The consequences for fixed income trading

The Debt Office has pointed out the risk that inadequately designed transparency rules would harm the Swedish fixed income market. In this final section, we develop the grounds for these apprehensions.

MiFID is a regulatory regime originally drawn up with equity trading in mind. In equity markets, order-driven trading dominates. This is also a market where small transactions, initiated by non-professional actors, are regularly handled parallel to large transactions.

Trading in interest-bearing securities has entirely different characteristics. This is typically price-driven, i.e. there are actors – market makers – that on a continual basis indicate the prices at which they are willing to buy and sell securities. This market is also completely dominated by professional actors that carry out large value transactions. It is thanks to the market makers being prepared to temporarily purchase, or sell, securities against their own balance sheets, that this is possible. One condition for market makers to be willing to temporarily absorb these risks is that they are given the room to neutralise their position without it being publicly known which transaction they are realising. This means that they can resell (or rebuy) smaller quantities of bonds, without the market price being unduly affected, i.e. moving in a direction that is disadvantageous to them.

This form of trading offers professional investors good liquidity (in the sense of immediacy, i.e. that they can quickly realise large transactions) and depth. Professional actors get information regarding prices through screen prices and also through their contacts with several market makers. This type of trading is thus already characterised by sufficient pre-trade transparency to meet the needs of investors.

There are also no signs of the market makers engaged in the Swedish trade in interest-bearing securities, under cover of insufficient transparency, profiting at the expense of investors (or the issuers). The market is dominated by investors that know how to protect their own interests and who cannot be considered to be in a disadvantageous position vis-à-vis the market makers. Instead, the level of transparency that characterises the market should be seen as an informational equilibrium. The investors are generally prepared to accept incomplete information with respect to transactions that have been performed in exchange for the good liquidity that the market makers are able to offer as a result of the deferred reporting of transactions. As such, there is no market failure.

Enforced transparency that fails to take account of the mechanisms upon which market maker trading is based could have a deleterious effect upon trading and rather *be responsible for creating* a market failure. The market makers would be forced to be more careful and decrease the volumes that they are prepared to buy and sell in single transactions. They would also be forced to increase the margin between purchase and offer price, since this is their buffer against disadvantageous price movements. Trading liquidity would be negatively affected, which would have the effect of scaring away investors who act for other reasons than that they need to invest money. Liquidity in a market is created through a self-reinforcing process. If it starts to go in reverse, corresponding mechanisms will enter into the picture, involving similar negative effects on liquidity.

Above, we have focused our discussion on the rules for post-transaction transparency. There are, however, several aspects to the proposal that are probably inappropriate from the perspective of providing the conditions necessary for well-functioning trading in government securities. In particular, we would like to draw attention to Article 17 in the draft proposal, which deals with the obligations of so-called systematic internalisers. The concept per se is obscure, but could be interpreted to mean that it covers market makers, including the Debt Office's primary dealers. In this case, these extensive requirements, including that these actors must offer the same terms to each client and also comply with the rule on most favourable terms stipulated in the MiFID, become applicable. These requirements increase the risks of being a market maker and, as such, contribute to elevated costs of trading in government securities. The requirement does not seem reasonable in light of the fact that primary dealers of Swedish government securities only have professional counterparties.

It is similarly unreasonable that it should be delegated to the Commission to – apparently freely – lay down limits for the volumes that an institution is required to offer other clients; see Article 18.2. In this context, there is not even mention of a differentiation being made in the light of "type and volume", or other factors that might exist. The Debt Office has a difficult time envisioning that a volume limit that works for the German government securities market would work for that market in Malta, or to the Swedish corporate bond market. The picture that emerges – in this regard as on many other points – is of a proposal without any clear relationship to the actual markets for which the rules have been conceived.

Liquidity is characteristic of the secondary market, but deteriorated conditions for trading in securities also affect the primary market, i.e. for the issuer of a given security. Investors will require compensation for increased liquidity risks by demanding higher required rates of return in the primary market. As a result, the financing costs of the government and other issuers will increase.

The sensitivity of a given market to extensively applied requirements on reporting of completed transactions is determined by a number of factors. One is the size and access to other risk management instruments. For example, turnover on the German government securities market is high and many active investors are involved. In addition, market makers can use derivative instruments in order to manage a large part of the risks to which they are exposed.

On smaller markets, such as the Swedish one, comparable options do not exist. First of all, access to derivative instruments is much more limited. For peripheral euro markets, the problem is probably even worse. In light of the large fluctuations in interest rate spreads to Germany, it is now very risky to use derivatives based on German interest-bearing securities as the underlying asset. At the same time, the internal markets are likely underdeveloped given that they were superfluous as long as there was no difference between the euro debt securities of the given countries. Sweden is therefore not likely to be the only smaller country with reason to eye the prospect of an ill-considered application of the regulation with apprehension.

A differentiation is indeed mentioned in the regulation, at least with respect to transparency rules, but in the light of the complexity that characterises the creation (as well as disappearance) of liquidity in a given market, it is not at all clear that it will be possible to draw up a regulatory regime that takes due account of all relevant factors.

The Commission's proposal represents ultimately an attempt to change complex market mechanisms. This is done without a clear analysis of the way in which these mechanisms are flawed, and also lacks a basic insight with respect to how they function. There are therefore strong reasons for Sweden to strive for fundamental amendments to the proposed regulatory regime before it enters into force.

The Director General of the Swedish National Debt Office, Bo Lundgren, has made a decision with respect to this case, following a presentation by Chief Economist Lars Hörngren. Head of Department Thomas Olofsson also participated in the final preparations.

Bo Lundgren

Lars Hörngren