Discussion paper response

Transparency and liquidity: trade transparency and a well-functioning market for mortgage-credit bonds

April 2017

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment the Finanstilsynet's Discussion Paper on transparency and liquidity (trade transparency and a well-functioning market for mortgage credit bonds). AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is registered on the EU Transparency Register, registration number 65110063986-76.

1. Introduction and general remarks

As part of MiFIR/D II, new transparency requirements will be introduced for bonds and many other instruments. AFME shares the view of the Finanstilsynet that these changes will be beneficial to the market, if they take into account the specificities of each asset class and follow a balanced approach. This is why AFME has, since very early on in the Level 1, and later Level 2 process, argued for a cautious and accurate calibration of the transparency regime under MiFID II/R: the activity of market making and liquidity provision needs to be protected and implemented carefully to avoid a cliff-effect after go-live. To that effect, we welcome the fact that ESMA and National Competent Authorities have been mindful of our concerns.

AFME notes that, in April 2016, and in line with those concerns, the European Commission requested ESMA to phase-in the application of certain parts of the future transparency regime to mitigate possible liquidity risks to bond markets. Subsequently, ESMA amended its RTS to adopt this approach. This highlights the potential disruption that transparency could cause on certain markets, should it be calibrated inaccurately. We set out below our views on pre- and post-trade transparency, and our preferred applications of those, to get to an optimal and well-calibrated transparency regime.

In relation to the consideration of an extended deferral regime it is important to draw specific attention to the following points:

- AFME is concerned that different deferral regimes could result in fragmented markets, due to regulatory arbitrage discriminating against jurisdictions that offer limited deferral periods, thereby negatively impacting end investors.
- If market makers/liquidity providers believe they might not have sufficient time to hedge/unwind their potential inventory position, they will either add in an additional cost to reflect that risk or simply not quote, in turn impacting the liquidity and competitiveness of the asset managers.

Association for Financial Markets in Europe
London Office: 39th Floor, 25 Canada Square, London E14 5LQ, United Kingdom T: +44 (0)20 3828 2700
Brussels Office: Rue de la Loi 82, 1040 Brussels, Belgium T: +32 (0)2 788 3971
Frankfurt Office: Skyper Villa, Taunusanlage 1, 60329 Frankfurt am Main, Germany T: +49 (0)69 5050 60590
www.afme.eu

Company Registration No: 6996678 Registered Office: 39th Floor, 25 Canada Square, London E14 5LQ
AFME is registered on the EU Transparency Register, registration number 65110063986-76

- Harmonised deferral regimes ensure a level playing field between domestic vs other EEA participants with no negative impact to liquidity.

2. AFME view on waivers and deferrals

1. Pre-trade transparency waivers

AFME is of the view that waivers from pre-trade transparency requirements should be granted in relation to:

- orders that are large in scale
- orders held in an order management facility pending disclosure
- actionable indications of interest in request-for-quote and voice trading systems, and
- derivatives that are not subject to the trading obligation under article 28 of MiFIR, and other financial instruments for which there is not a liquid market.

Failure to provide waivers from the pre-trade transparency requirements would be a deterrent to liquidity provision and market making, as well as cause undue risk to entities engaged in those activities.
We note the fact that, as noted by the Finanstilsynet, most trading in Danish mortgage-credit-bond market is done over-the-counter (OTC). Unless an investment meets the systematic internaliser thresholds in that market (i.e. trades on a frequent and systematic, and substantial basis), it will not be subject to pre-trade transparency and as such, its firm quotes will not be published. The few firms that do, in fact, trade under SI status need to be able to waive their pre-trade transparency obligations in order to make sure they are not put at a disadvantage compared to other firms, particularly when they trade in large volunes.

We stress the need for waivers to be made available and applicable from day 1 of MiFIR effective application. In addition, we also highlight to the Swedish FSA that further clarity is also required on the extension of this requirement to systematic internalisers as per MiFIR Article 18(2) which states that SI pre-trade transparency disclosure requirements may be waived where the conditions specified in Article 9(1) are met.

2. Post-trade transparency deferrals

AFME appreciates that each National Competent Authority (NCA) will have to consider their approach to deferred publication in relation to those transactions individually. However, we believe a European coordination across NCAs, to the greatest extent possible, will benefit the industry and ensure relative consistency around a T+2 deferral, which we think would be optimal. We are concerned that each Member State implementing a different deferral framework would result in a highly-fragmented regime across Europe.

Post-trade deferrals are important to ensure that market makers have sufficient time to hedge their positions and protect themselves from the risks they take by providing liquidity to the market. In many illiquid markets it can take several months for liquidity providers to hedge/unwind their exposures and, in liquid markets, large trades are often only proxy-hedged initially, then warehoused by liquidity providers for significant periods of time. It can take weeks or months to fully exit such positions. The inability to de-risk before the size of a LIS or illiquid trade is made public will act as a significant deterrent to the provision of liquidity. For price formation purposes there is little value to general market participants in knowing the exact size of a trade, particularly compared to the adverse consequences to liquidity providers of excessive transparency of trade size. It should be sufficient for the market to know that a large or illiquid trade has taken place and this can be achieved by including an appropriate "flag" when the other details of the trade are published after the initial, shorter, deferral period.

In addition to ensuring that market-makers and other liquidity providers have sufficient time to hedge their exposures, there are other reasons why an extended time period of deferral is needed in respect of volume. There are circumstances in which the publication of trade size may contribute to market instability. A planned cross jurisdictional, cross currency acquisition is a practical example of this. Such transactions have significant exchange rate risk and it is common for the take-over to be preceded by large foreign exchange forward transactions (sometimes conditional on completion of the transaction) some days or weeks in advance of expected finalisation of the take-over. In the absence of extended volume omission, a very large foreign exchange forward transaction would be published, which could give rise to rumour and speculation, could result in distortion of other market prices, and could even imply a leakage of material non-public information. The period of volume omission needs to extend at least beyond the typical tenors of these transactions. Similarly, pre-hedging of new bond issues can give rise to activity in interest rate swaps, and large trades being published post-trade without volume.

On the MiFIR deferral regime specifically, AFME is of the following view:

We do not believe any additional information should be made public during the standard deferral period [i.e. as per MiFIR 11(3)(a) and RTS2 Article 11(1)(a)]as it would undermine the objective of the initial deferral by providing insufficient time for market makers to exit risk positions for large / illiquid transactions, and would add to the complexity and expense of the whole deferral process for no advantage. AFME believes the 4-week supplementary deferral for volume, as per MiFIR 11(3)(b), and RTS2 Article 11(1)(b), is critical to protect market makers, liquidity providers, and allow hedging of risk. In its Discussion Paper, the Finanstilsynet recognises the key role of market makers, not only in the mortgage-credit bond markets, but for all products. For example, Primary Dealers play a key role in the liquidity of Danish government bonds by committing capital not only in the primary market, but also in ensuring liquidity in the secondary. Post-trade deferrals are important to ensure that market makers have sufficient time to hedge their positions and protect themselves from the risks they take by providing liquidity to the market. In many illiquid markets, it can take several months for liquidity providers to hedge/unwind their exposures and, in liquid markets, large trades are often only proxy-hedged initially, then warehoused by liquidity providers for significant periods of time. It can take weeks or months to fully exit such positions. The inability to de-risk before the size of a LIS or illiquid trade is made public will act as a significant deterrent to the provision of liquidity. For price formation purposes, there is little value to general market participants in knowing the exact size of a trade, particularly compared to the adverse consequences to liquidity providers of excessive transparency of trade size. It should be sufficient for the market to know that a large or illiquid trade has taken place and this can be achieved by including an appropriate "flag" when the other details of the trade are published.

In addition to ensuring that market-makers and other liquidity providers have sufficient time to hedge their exposures, there are other reasons why an extended deferral period is needed in respect of volume. There are circumstances in which the publication of trade size may contribute to market instability. A planned cross jurisdictional, cross currency acquisition is a practical example of this. Such transactions have significant exchange rate risk and it is common for the take-over to be preceded by large foreign exchange forward transactions (sometimes conditional on completion of the transaction) some days or weeks in advance of expected finalisation of the take-over. In the absence of extended volume omission, a very large foreign exchange forward transaction would be published, which could give rise to speculation, could result in distortion of other market prices, and could even imply a leakage of material non-public information. The period of volume omission needs to extend at least beyond the typical tenors of these transactions. Similarly, pre-hedging of new bond issues can give rise to activity in interest rate swaps, and large trades being published post-trade without volume.

Example – a Denmark based asset manager is selling an illiquid corporate bond to a dealer (who is not an systematic internaliser, therefore the post trade reporting obligation sits with the seller). The dealer sits in a jurisdiction that has granted a supplementary deferral of T+4 weeks, but the Danish asset manager is required to report T+2 therefore the volume traded is in the public domain. The dealer (based in a T+4 weeks jurisdiction) may not have been able to hedge/ unwind the trade before it's known publicly and will therefore factor that into any price/spread quoted for clients sitting in T+2 reporting jurisdictions.

Example - Danish asset manager wants to sell a block size, DKK 75 MM, of corporate bond: DK0030320866 HALDOR TOPSOE 3,625% 17/04/20

	Scenario 1 Asks a quote from a local market maker who is an SI	Scenario 2 Asks a quote from a non-Danish non-SI, from country EEA1	Scenario 3 Asks a quote from a non-Danish SI, from country EEA2
Deferral regime applied	Denmark	Denmark	EEA2
***Assume* Deferral rules**	End of T+2 for price & volume	End of T+2 for price & volume	End of day T+2 for price, 4 weeks for volume
Price impact	If market maker considers that there is a chance that all/most risk cannot be warehoused/unwound, may charge more or not quote	If market maker considers that there is a chance that all/most risk cannot be warehoused/unwound, may charge more or not quote	Market maker will be generally confident that all/most risk can be warehoused or unwound within 4 weeks so price will be competitive
Liquidity impact	Danish participants may be put at a competitive disadvantage versus their EEA counterparts – both asset managers and liquidity providers		

With this in mind, AFME believes the 4-week deferral extension [i.e. as per MiFIR 11(3)(b), and RTS2 Article 11(1)(b)] in conjunction with the initial standard deferral is extremely critical.

AFME's suggested approach to the NCA deferral process is as follows, and follows ESMA's approach outlined in its September 2015 Final Report (p153) in recommending that the FCA use:

- In relation to instruments that are not sovereign debt, its powers under MiFIR 11(3)(b) [as well as RTS2 Article 11(1)(b) and Article 11(2)(a)]; and
- In relation to instruments that are sovereign debt, its powers under MiFIR 11(3)(b) and MiFIR 11(3)(d) [as well as RTS2 Article 11(1)(b) and Article 11(2)(c)].

This would achieve the following post-trade transparency regime:

- No details published until 7pm local time on T+2 if transaction qualifies for the standard deferral. At 7pm on T+2, utilise 11(3)b) such that all details of transactions on individual transactions are published on T+2 except volume
- Within the extended 4 week deferral period, no details published on volume, whether aggregated or not, for all eligible transactions
- Volume of individual transactions published after 4 weeks except if transaction in a sovereign debt instrument
- No publication of volume for an indefinite period for sovereigns even after 4 weeks; instead aggregated volume for sovereign instruments published on the Tuesday following the expiry of the 4 week deferral before 9:00 local time as per RTS2 Article 11(2)(c).

		Post-Trade Transparency Disclosure – Proposed AFME framework		
		Price	**Volume (Non-Sov)**	**Volume (Sov)**
LIQUID	**≤ SSTI**	Real-time	Real-time	Real-time
ILLIQUID	**≤ SSTI**	At 7pm T+2	T+4 weeks*	T+4 weeks (Aggregated)**
LIQUID & ILLIQUID	**>SSTI & > LIS**	At 7pm T+2	T+4weeks*	T+4 weeks (Aggregated)**

* All det**ails of individual transactions /** ** Aggregation must be for <u>several transactions</u>. To protect against situation where only one trade is executed in the week in any given ISIN, "aggregation" should be by issuer.

3. Special consideration for the Danish mortgage-credit bond market

AFME is mindful of the specificities of the Danish mortgage-credit-bond markets, as highlighted by the Finanstilsynet in its Discussion Paper. We note that Denmark currently has national regulations in place on post-trade transparency, particularly the requirement to publish trading in mortgage-credit bonds as close to real-time as possible and by no later than three minutes after the transaction has taken place, with the possibility to defer publication of large transactions to the close of business on the day of the transaction. We take note that, as far as post-trade transparency under MiFID II/R is concerned, granting all the available exemptions would lead to less transparency post-trade than is currently the case, and to that respect will defer to the Danish Securities Dealers Association to comment on this specific market. We would support a continuation of the existing regime should market participants in Denmark find it beneficial. However, for other products, and from a pan-European perspective, we wish to make the below comments.

AFME is particularly concerned about the possible lack of harmonisation across EU jurisdictions and how this could lead to a fragmentation of liquidity for those products that are traded across the European Union. AFME believes it is in the interest of market liquidity and financial stability that NCAs should look to adopt deferral regimes as aligned as possible, and that ESMA should encourage this process: there is a real concern that non-harmonisation could lead to liquidity fragmentation, particularly for those products traded across jurisdictions, with trades qualifying for a deferral more likely to be traded in jurisdictions that offer the extended period, particularly those offering the 4-week supplementary deferral for volume. This could lead to regulatory arbitrage, an unlevel playing field between various jurisdictions, and penalise end-investors who should be able to access the same level of liquidity in each country.

AFME is mindful of the Finanstilsynet's concerns around how the exemption from the transparency requirements could have implications for the various type of market participants, particularly small investors.

However, we believe these market participants would still benefit from the proposed pre-trade transparency regime, and our proposed post-trade framework. AFME is of the view that a T+2 deferral for price still provides important and valuable price transparency, including for illiquid instruments. On the contrary, and as stated above, there is little value for market participants to know the exact size of a trade for price formation purposes.

We also note that Finanstilsynet acknowledges that despite exemptions available to them, market participants could decide to publish information on orders and/or transactions anyway.

3. Conclusion

The ability to benefit from available waivers from pre-trade transparency and deferrals from post trade transparency is critical for AFME's Members. On post-trade specifically, while we are mindful of the regime currently in place for mortgage-credit bonds, we would like to encourage the Finanstilsynet to allow the maximum supplementary deferral of 4 weeks for volume (aggregated for sovereign bonds), as well as a "dark" T+2 deferral period for price.

With a view to ensuring well-functioning and more integrated non-equity markets, AFME considers that:

- the harmonisation of deferral regimes across the EU is essential to prevent regulatory arbitrage and preserve a level playing field across EU for investment firms and investors who wish to avoid a liquidity fragmentation;
- the extended deferral regime, using the supplementary deferral available for NCAs to use, as set out in the table below (price published up to T+2, volume T+4 weeks except for sovereign bonds where volume is published in aggregated form at T+4 weeks) for all trades above a size specific to the instrument (SSTI) and all trades in illiquid instruments is key for market makers and other liquidity providers to have sufficient time to hedge their positions and protect themselves from the risks they take by providing liquidity to the market.

AFME would welcome the opportunity to discuss the points covered in this response in more detail with the Finanstilsynet at the earliest opportunity.

AFME contacts

Victoria Webster, victoria.webster@afme.eu +44 (0)20 7743 9689

Charles Deslandes, charles.deslandes@afme.eu +44 (0)20 7743 9684