Market Transparency and Best Execution: Bond Trading under MiFID

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1. INTRODUCTION

2. MIFID's EQUITY MARKET TRANSPARENCY

3. SHOULD MIFID'S TRANSPARENCY REQUIREMENTS BE EXTENDED TO BOND MARKETS?

4. BEST EXECUTION IN TRANSPARENT BOND MARKETS

5. CONCLUDING REMARKS

1. INTRODUCTION

- ✓ The type of instrument traded and the structure of the relevant market have an impact on best execution
  - shares are generally traded in order-driven and centralised markets
  - bonds are mainly traded off-exchange, in quote-driven and decentralised markets

- ✓ Market transparency has an impact on best execution
  - contributes to price discovery making markets more efficient
  - can improve liquidity if customers have to search for the best quotes

- ✓ Market transparency is needed for best execution, particularly with respect to retail investors, whose presence is substantial in some countries

2. *MIFID'S EQUITY MARKET TRANSPARENCY*

✓ Market transparency was regulated for the first time under the ISD, which

- included minimum standards for post-trade transparency in regulated markets
- provided considerable latitude for Member States in the implementation of those standards, particularly with respect to bonds and other debt instruments
- allowed Member States to require transactions in equity securities to be carried out on a regulated market

- ✓ Throughout the MiFID's formation political agreement was reached to dismantle national barriers and promote competition in the offer of trading services with respect to listed shares
  - the new Directive allows internalisation of orders and includes provisions concerning transparency, order handling, conflicts of interest and best execution
  - transparency obligations are aimed at remedying the fragmentation of markets which derives from competition in the offer of trading services

- ✓ Pre-trade transparency proved to be a controversial subject, as already seen for the ISD
  - political agreement was not too difficult to reach concerning regulated markets and MTFs
  - the real controversy centred around whether pre-trade transparency should be imposed upon internalisers
  - the European Commission
    - in 2002, suggested that internalised market orders and limit orders left unexecuted by internalisers should not be reported

– however, in its proposal for a directive, accepted the opposite view and included provisions mimicking the US pre-trade transparency rules

» “quote rule” (adopted by the SEC in 1978 and extended in 1996 to Nasdaq market makers who post quotes in ECNs)

» “limit order display rule” (adopted in 1996, requires dealers who accept limit orders and specialists to display these orders, when the order is placed at a price superior to the market maker or specialist’s own quotations)

- ✓ The Commission's proposal generated an intense political debate
  - investment intermediaries insisted that the abolition of concentration rules could be effective only in the absence of other hindrances to off-exchange trading
  - banks in the Continent supported the imposition of pre-trade transparency obligations on dealers in order to create a level playing field between trading venues or entities
  - stock exchanges defended pre-trade transparency requirements as a means to achieve efficient price discovery in fragmented markets

- a compromise solution was found, at last, in the European Parliament
  - article 22 (2) MiFID requires investment firms to make public limit orders concerning shares admitted to trading on a regulated market, which are not immediately executed under prevailing market conditions
  - article 27 MiFID requires internalisers to publish firm quotes only if a number of conditions are met
  - moreover, systematic internalisers must execute their clients' orders at the price quoted when receiving the order
    - » in the case of orders from professional clients, systematic internalisers may execute those orders at a better price
  - in addition, systematic internalisers may choose which investors should have access to their quotes, provided that they proceed 'in an objective non-discriminatory way'

- ✓ The reasons for a similar treatment of internalisation are made clear by the formation process of the MiFID

  - the rules just examined have satisfied the incumbent exchanges' request for a level playing field
  - the internalisers' duty to deal with all investment intermediaries has reduced the fear that internalisation by large investment banks may subtract liquidity from the stock exchanges

- the limits of the MiFID’s response to internalisation are apparent
  - the relevant duties are subject to restrictive conditions
  - the content of these duties has been diluted through the MiFID’s negotiation to the point that their regulatory bite is relatively modest

3. *SHOULD MiFID'S TRANSPARENCY REQUIREMENTS BE EXTENDED TO BOND MARKETS?*

✓ The MiFID's transparency rules do not include debt instruments in their scope

- the interest groups involved in the discussion were been different for bonds, which are predominantly traded OTC, with transactions on listed instruments mainly occurring off-exchange

- the core question dealt with by CESR in its advice was whether there would be ‘convincing evidence of a market failure with respect to market transparency in any of the instrument markets under review’
  - the vast majority of the respondents felt that there was no market failure
  - CESR specified that the extent of information asymmetry may differ depending on the instruments traded
  - CESR’s general answer was that there is no evident market failure in respect of market transparency in bond markets

- the Commission's Report reached similar conclusions
  - with respect to the retail bond markets, the Commission accepted CESR's view that investors have 'sub-optimal' access to price information
  - with respect to wholesale markets, the Commission accepted the argument that no convincing case of a market failure has been made out
  - by way of conclusion, the Commission argued
    - » there does not seem to be a need for expanding the MiFID's transparency requirements to financial instruments other than shares
    - » market participants appear to be well-placed to address the same through self-regulatory initiatives

- a few comments may be helpful
  - a majority of interventions came from trade associations of banks, securities firms and other professionals
  - for retail investors the concept of ‘sub-optimality’ seemed more appropriate than that of market failure
- the Commission’s final recommendation suggested self-regulation of post-trade transparency
    - pre-trade transparency did not appear fit for regulation
    - best execution emerged as one of the key arguments supporting enhanced market transparency, which would improve retail investors’ ability to control order execution by their intermediaries

4. BEST EXECUTION IN TRANSPARENT BOND MARKETS

✓ MiFID is aimed at enhancing competition between trading venues

- the Directive's opposition to domestic concentration rules was motivated by competitive concerns
- best execution was regulated in view of promoting competition between trading venues
- however, the principle of best execution was specified in ways which could make competition in share trading more difficult for new entrants and in the end protect the incumbent exchanges

- ✓ MiFID offers a broad definition of best execution which deserves approval
  - a flexible concept of best execution makes competition between trading venues easier
  - several provisions of the MiFID and the implementing Directive constrain the flexibility of best execution by making its requirements more specific
    - particularly in the case of execution of orders for retail clients, the best execution factors enumerated by Article 21 (1) of the MiFID are incorporated, at level 2, in the narrower criterion of ‘total consideration’
    - this approach has an impact on competition between trading venues, to the extent that reference to the traded instruments’ price puts established and more liquid venues at a competitive advantage

- ✓ Three examples show the complexity of best execution analysis in bond trading

  - the first refers to bonds which are only traded OTC, with liquidity provided by one or more dealers
    - when the retail customer asks her broker to buy similar bonds, the latter will look for the best offer available and execute the transaction with the relevant dealer

- the second hypothetical case refers to bonds which are admitted to trading on a regulated market and are actually traded on the same market and on another venue (regulated market or MTF)

  - assuming that the broker has access to both venues and that they offer both pre-trade and post-trade transparency, compliance with best execution will be relatively easy
  - however, the broker might also choose to trade bonds on a single venue, in which case best execution is satisfied by trading on this venue, provided that the performance of the same is periodically compared with that of the other venue

- the third hypothetical is a combination of the previous two
  - assume that bonds are admitted to trading on a regulated market and are traded both on or off-exchange, and that the regulated market offers pre-trade and post-trade transparency, whilst off-exchange transactions are not published under the applicable rules
  - this is a case of competition between a transparent and an opaque market
    - » economic theory predicts that the opaque market will prevail
    - » assuming that opaque dealers quote the best prices, the broker will transact off-exchange

5. *CONCLUDING REMARKS*

- ✓ Transparency is important for best execution in bond trading and market-led solutions directed to enhance post-trade transparency deserve approval
  - in the case of regulated markets and MTFs, both pre-trade and post-trade transparency are often already available
  - for OTC transactions pre-trade transparency is more difficult to obtain, as changes to the market microstructure may be needed

- post-trade transparency, on the contrary, is feasible for OTC markets
  - a crucial question needs to be answered, concerning the time when the relevant information should be published
  - in view of the Commission's consultation, the International Capital Markets Association (ICMA) suggested possible market-led mechanisms for bond market transparency
  - core questions to be addressed
    - » should real-time or end-of-day publication of data be chosen
    - » should post-trade transparency only apply to liquid bonds or also to illiquid ones?
    - » what size of transactions should be covered?

- ✓ The Commission restrained from doing more than suggesting a ‘careful’ design for self-regulatory initiatives

  - it remains to be seen whether market participants will be able to solve their collective action problems and strike the right balance between transparency and liquidity