

## **ICMA Annual General Meeting and Conference**

**Paris, Friday 27 May 2011**

Keynote speech by Jean-Pierre Jouyet,  
Autorité des Marchés Financiers Chairman

### **Please check against delivery**

Let me begin by extending my warmest thanks for this opportunity to speak to such a prestigious assembly. I am delighted to be able to share some of my impressions of the way our markets are functioning today.

Although you have chosen not to devote a workshop specifically to the G20 as such, some of the subjects you have selected for your panels do relate to it. I am thinking, for example, of yesterday's discussion on "coordinated global securities regulation", and also the "future of capital markets" and, in a few minutes, the "liquid and transparent markets panel". Nothing could be more logical, given that since the G20 summit in Seoul, the question of the proper working of the markets has finally been given its place on the international regulation agenda. There are two reasons for this:

- = the new prudential standards alone cannot suffice to meet the regulation needs revealed by the crisis;

- = we now know that these revised prudential standards will oblige us to turn increasingly to the markets to finance the economy; these markets must therefore operate in an optimal manner. This is not the case today and their two mainstays of transparency and liquidity are under strain.

We will now look at the reasons for this and see whether there are any solutions.

## **1 – Transparency first**

The end of order centralisation on national legacy exchanges in Europe and the United States has brought a welcome wind of competition to markets previously dominated by national monopolies. This opening up to competition has accelerated the modernisation process and brought about the emergence of new market players. The fees billed for the sole execution of transactions have fallen under the twofold pressure of this competition and of technical progress. There is another side to the coin, however: new facilities have developed that are sometimes less transparent. Increased market fragmentation is making access to market information more costly. Finding the best execution price is more difficult. The IT investments required to keep up have soared, meanwhile, raising fears of quasi-oligopolies among market intermediaries.

And yet without transparency there can be no confidence in markets, especially in times of crisis. The same also goes for financial information: just take a look at the reassuring effect publication of bank stress tests had in the US, in particular to ease the excessive suspicion surrounding such securities. Similarly, the securitisation market will not recover until we provide investors with detailed information about each of the assets held by special purpose vehicles.

What is true of banks and investment products is also true of the markets themselves, and it is a lasting return of investor confidence that is at stake. I see four areas of work to improve transparency on our markets.

These are areas we must address on the occasion of the review of the Markets in Financial Instruments Directive Financiers in Europe, but they are just as relevant to the United States and to all other financial markets.

**First area: reduce the share of OTC transactions.**

The shares quoted for such transactions vary from 15 to 40% in Europe. The Authority I chair would estimate the figure at the upper end of that range, but the most disturbing thing here is that we are not even capable of providing reliable figures, which says much about the task that awaits us. Whatever the case, this ad hoc form of trading should remain the exception, for it is only the ordered, transparent bringing together of the greatest number of buyer and seller interests that can guarantee fairness for all market players and formation of the right price.

The volume of OTC trades must therefore be reduced and execution of share transactions in transparent, organised multilateral facilities encouraged. We must begin by giving a positive definition of “over the counter”, rather than defining the term by default, as we do today, as anything that is not executed in a facility. This form of trading must be reserved for clearly identified types of transactions which are not supposed to contribute to price formation, such as complex transactions combining cash and derivatives.

**Second area: reduce to the strict minimum the exceptions to pre-trade transparency in organised facilities.**

There are far too many exemptions to the principle of pre-trade order transparency, despite this principle being accepted by all.

Additionally, the principle only applies to the equity market. This affects the way the market works and raises questions about market integrity and efficiency, as well as about the fairness of competition rules across the various types of systems. The size of the transactions made on “dark pools” has also dropped sharply, whereas the exemption was originally designed to allow large blocks to be traded without disrupting the market.

All the exemptions therefore need to be scrutinised and only those that are fully justified should be accepted. The regulator also needs to have access to all the order books in order to be able to detect price manipulations in the future. This is the approach that has been adopted in the United States with the "consolidated audit trail" project. I urge Europe to follow the same path.

**Third area: consolidation and organisation of post-trade information.**

Investors and issuers must be able to get a reliable and consolidated view of all transactions. Although the information does exist at present, it is so dispersed that it is very difficult – at least in Europe – to reconstruct the transaction history. It is a problem both for the industry and for regulators, who are obstructed in their supervisory role by the mediocre quality and scattered nature of the data collected.

**Finally, the fourth and last area of work is to guarantee this transparency more effectively: apply the same rules to all markets, not just equity markets.**

The principles that apply to the equity market also apply to the others, starting with the bond, derivatives and securitisation markets. The only difference is that with some of these markets, we sometimes have to start from scratch, being careful to tailor the rules to each market and each instrument as each one has its own specific features.

Let's take the case of the OTC derivative market. Not only is there no rule for public transparency, but even the regulators themselves do not have access to a minimum amount of information about OTC derivative transactions. This is why regulators on either side of the Atlantic have put regulation of these markets at the top of their list of priorities. You know about the American projects in the Dodd-Frank Act and the draft EMIR regulation. The approach is the same: a clearing obligation which I won't go into here because it is dictated more by financial stability requirements than those of transparency, but above all an obligation to record transactions in trade repositories.

The most difficult issue at present is to reach an agreement between Europeans and Americans on the most precise possible format for the data which is to be collected, in order to avoid the coexistence of two different reporting systems. This need for convergence obeys the principle of reality and economics on globalised markets. The first step, one which is absolutely clear to all regulators, is the set-up worldwide of a single identifier for each market player. There is an extra challenge for the Europeans: to guarantee the European regulator access to the data, we need a trade repository located in Europe and governed by rules guaranteeing these regulators unconditional access.

The second subject is the transfer of OTC derivative trading to more transparent facilities. Once again, on the world market, Europe and the States must strive to reach an agreement on rules that are if not strictly identical, then at least as harmonised as possible, both on the products that should be traded on these markets and on the regulation of these new facilities. Irrespective of their name, "swap execution facilities" in the United States or "multilateral trading facilities" in Europe, they must be as transparent as possible and broadly accessible to those involved, whoever they are.

As regards the bond market, in Europe the MiFID review gives us the opportunity to promote trading of sufficiently-liquid interest-rate products in organised, transparent multilateral trading facilities. As you know, dedicated bond trading facilities are currently being set up in Paris. These projects echo the desire among professionals and governments alike to offer greater transparency in bond trading. They will prove, for example, that it is possible to repatriate trading from markets considered as being low liquidity, and hence dominated by OTC, to organised facilities.

## **2 – After transparency, the second pillar of the sound working of the markets: liquidity.**

Ever since I took up this position, the people I have talked with only have this word on their lips. I agree that liquidity is essential to the sound working of the markets. But first we need to know which liquidity we're talking about.

In my view, the ultimate purpose of the markets is still to finance the economy. And it is first and foremost on the primary markets, via the issue of new shares and debt securities, that issuers can finance themselves. Although secondary markets are useful in financing the economy, they do so indirectly: they facilitate trading of securities and therefore disinvestment by those investors who so wish; they provide price references for future transactions on the primary market. The real issue is therefore to guarantee this liquidity, including when the markets are under the greatest strain, rather than to gain a few more tenths of a cent on bid-offer spreads on securities that are already perfectly liquid.

**The first point is that liquidity for its own sake makes no sense if it doesn't stand up to the first jolt (secousse) on the market.**

Remember 2008 and the way the markets gradually seized up, one by one: first the complex securitisation markets; next, all securitisation markets; and last, bond markets, first long-term then short-term. This gradual freezing observed on debt instrument markets did not occur, however, on equity markets (in particular for large caps). Better organised and with more transparent multilateral trading facilities, these markets even acted as liquidity reservoirs.

So we can see that the most transparent and open markets are also the most liquid ones in difficult times, because they inspire confidence. This is why regulators are demanding that as many transactions as possible be transferred to trading facilities.

**Second point: excess liquidity only makes sense if it brings something to the real economy.**

As you have probably realised, the big question I am raising here is that of the social utility of high frequency trading.

The impact of 'high frequency trading' on the microstructure of the markets has not yet been sufficiently studied. While it is true that a reduction in bid-sell spreads on large-cap securities has been demonstrated, this has been at the price of a multiplication of small-sized orders. However, I think it is a little early to state that the figure calculated in this way shows that the market works better and that markets thus offer a better service to issuers and investors. I won't deny that tighter bid-sell spreads are of interest to market players. But more than anything else, these players want the market to be comprehensible. They want to understand the market movements taking place before their eyes. They want, in the space of a few seconds or minutes, to have sufficient predictability as regards the prices at which their orders may be executed. In short, they want to be able to venture onto the markets with full confidence. But high frequency trading involves changes to order books that are so fast that from the moment when an investor places his order and the moment when the order is executed, the book has already moved on. This permanent instability is a source of concern among investors.

Similarly, the execution rate of orders has dropped; the possibility of cancelling an order after a few microseconds contributes to a **feeling of artificial, fleeting** (*fugace*) **or uncertain liquidity**. The market crash of 6 May 2010 showed for example that high frequency traders could withdraw from the markets very swiftly at precisely the moment when those markets need level-headed investors.

Ultimately, this reduction in the price spread only benefits the market players who are constantly moving back and forth and who close their positions at the end of the day. It is of no interest to issuers because it has virtually zero effect on their financing terms on primary markets. It does not serve long-term investors, who perform few transactions and always do so based on a rigorous analysis of the fundamentals. Last, it hinders regulators in their market supervisory role. They find it harder and harder to detect and sanction market manipulations by people using these algorithm tools.

My aim is not to criticise technical progress and the new trading methods that have been developed. But the functioning of the markets has to be organised by precise rules for these markets to return to their role of financing the economy. To ensure permanent liquidity in order books, should we impose a minimum period of time before orders can be cancelled, or a pricing system for cancelled orders? Should we place curbs on latency? Should pricing increments be limited? Should we simply confine ourselves to establishing circuit-breakers that put an end to domino effects on markets when algorithms get out of hand? This last measure, which is rather like a pilot switching from autopilot to manual mode when he needs to take control, is necessary in my view, in the same way as what has been decided in the United States.

As for the other questions raised, I won't claim to be able to give you definite answers this morning. However, I do know with certainty that the regulators will not have the financial or technical means necessary to keep up with market developments at their current pace. And so we will not be able to guarantee the integrity of these markets, which is our primary mission.

## **Conclusion:**

In the introduction I mentioned the fact that your work on the functioning of the markets often brings us back to the G20 agenda. I hope I have convinced you that this functioning is dependent on the two mainstays of transparency and liquidity – providing the latter is not artificial liquidity.

Will our efforts to consolidate the foundations of our markets pay off? Our only indicator will be the return of investors to the markets, starting with the equity market. I believe we need to adopt a more educational approach, but above all take their interests into greater consideration than we have done to date. This is why the G20 have also asked us to look at the question of protecting investors/consumers. This is not a figure of speech. In the United States, the UK and France too, regulators are getting organised in order to include this factor more effectively in their work schedule. But the signals we are really expecting must come from the industry. It must demonstrate that the client's interests should take priority over any other consideration. The industry has everything to gain by doing so, as tomorrow it will have to convince investors to remain loyal.

Thank you for your attention.

**1 *What lessons can be learned from the crisis about how to ensure that markets are liquid and transparent?***

The crisis has clearly demonstrated that ;

- **The liquidity of OTC markets is not robust** : on the bond and securitized debt markets for example, the liquidity dried up during the crisis. It is due to the fact that the market makers that usually buy and sell on the OTC markets under normal conditions, suddenly stopped providing bid and offer prices.
- **Even where such transactions could take place, most investors didn't know the price at which the transactions had been made because there was no transparency.** As a result, the pricing of securities was highly volatile and sometimes aberrant. For instance, at the top of the crisis, some AAA structured finance products were priced 50% of their initial value the first day and 80% one day later! And because of this absence of post trade transparency the investors were unable to value their portfolios correctly.

**Lessons to be learned :**

- we need less OTC markets and more multilateral platform negotiation, because OTC markets liquidity proved to be less robust during the crisis;
- we need more post-trade transparency.

***2 Should EU requirements for pre and post-trade transparency in MiFID be extended to bonds? Should bonds be treated in the same way as equities? Should wholesale and retail investors be treated in the same way? And should a distinction be drawn between regulatory disclosure and public disclosure?***

MIFID II should be an opportunity to introduce harmonised pre and post trade transparency at European level **for bonds**. With requirements adapted to the specificities of bonds, but very similar to those for equities.

**As regards pre-trade transparency, which is the transparency of the order books :**

There should be a general pre-trade transparency requirement, with some **limited exemption**, for instance **for large blocks trades** which could be executed on dark pools.

**As regards post trade transparency,** there is also **growing consensus** not only among regulators, but also among the industry, **in favour of more post-trade transparency**. The market should have adequate information on the trades, irrespective of whether they were concluded on an organised market or OTC, and irrespective of whether they are retail or wholesale transactions. As for equities, differed publication of price for large transactions could be introduced because the financial intermediary needs time to sell its position.

With a better post-trade transparency, all market participants would have equal access to price information, and the valuation of portfolios would be easier.

The challenge will be to find the right thresholds.

**Public disclosure, which I call “transparency”, should certainly not be confused with regulatory disclosure which we typically refer to “reporting” to avoid confusion.**

**Reporting of transactions to regulators** is a pre-requisite for regulators to be able to perform their market surveillance function and detect potential market abuse. It **must cover all transactions on all markets**. The AMF fully supports the suggestion made by the European Commission to extend the scope of the transaction reporting regime to include transactions on OTC derivatives linked to an instrument admitted to trading on a regulated market or an MTF.

In the same way as it supports a consolidated tape for post trade transparency on equities, the AMF supports a single and centralised reporting mechanism at EU level that would be more efficient.

**3 What would be the impact of pre and post-trade transparency requirements on liquidity? How much does that matter? Will there be benefits for issuers and investors?**

I really think that pre and post-trade transparency is beneficial to liquidity :

- with more transparency, we have less information asymmetries : all investors benefit from the information and can trade with more confidence.
- And with more liquid secondary markets, the bid-ask spread and hence the trading costs decrease, and the cost of raising capital or borrowing money for issuers also decrease.

And it is a virtuous circle : the more a market is liquid, the more it will attract participants and additional liquidity.

#### ***4 How should any pre- and post-trade transparency requirements be calibrated?***

The precise calibration of transparency requirements is indeed very important and must be precisely defined.

##### **For shares :**

- The information on transaction (what we call post-trade transparency) must be given to the market as soon as possible. The markets are highly liquid, and can absorb big trades. We need of course differed publication for very large trades, but no later than the end of the day. We agree on this with the proposal made by the European Commission to reduce the maximum delay for differed publication to end of day.
- For the transparency of order (pre-trade transparency), the exemption should be limited to large block transactions

For non equities, we need a detailed approach, instrument by instrument.

- the calibration exercise should be done by ESMA.
- For pre-trade transparency, the only exemption should be for block trades and the issue is to determine the threshold of the Block that would qualify for this exemption.
- For post trade transparency, we could for example have a partial transparency : we would not require the publication of the precise size of the transaction but only the existence of the transaction and the price.

**5 What role do OTC markets play post crisis? Should OTC trading be encouraged to move onto exchanges and multilateral platforms? What is the relationship between liquidity and exchange trading?**

First, let me remind you that the G20 asked us to bring as many transactions as possible on organized markets (especially for derivatives, but it is true for all instruments).

What is in my view an organized market:

- first it should be truly multilateral.
- it should be pre-and post trade transparent,
- It should offer non-discriminatory access;
- it should be under the supervision of regulators;
- it should have appropriate governance and organize the surveillance of members 'activities

OTC markets will still have a role either for less liquid instruments or for very specific transactions which do not have to participate in the price formation process ( e.g. complex transactions)

## **6 How should trades be executed? How should trading and clearing relate?**

Everything that is clearable does not always have to be traded on an organized market. And everything that is traded on a market should be cleared.

In the US, the Dodd Frank Act introduces a direct link between clearing and trading : if a derivative is cleared, it must be traded on a market.

In Europe, we don't have the same view because the level of liquidity required to allow for trading on a multilateral platform is more demanding than the one required to allow for central clearing.

Linking trading and clearing may restrict too much the scope of instruments subject to mandatory clearing.