TREASURY, RISK AND FINANCE PROFESSIONALS ACT

The Association of Corporate Treasurers

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Comments in response to

Review of the markets in Financial Instruments Directive (MiFID)

The European Commission

8 December 2010

February 2011

The Association of Corporate Treasurers (ACT)

The ACT is a professional body for those working in corporate treasury, risk and corporate finance. Further information is provided at the back of these comments and on our website www.treasurers.org.

Contact details are also at the back of these comments.

We canvassed the opinion of our members through our monthly e-newsletter to members and via the ACT website.

General

The ACT welcomes the opportunity to comment on this matter.

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Our members typically work in the corporate treasury function in non-financial companies and therefore make use of derivatives as customers of the financial services firms. Most of these companies do not engage in derivatives for trading or speculative purposes but rather to hedge various risks that arise from their company's commercial and financing activities. Over the years the variety of instruments available has increased as has the variety of risks that can be covered, expanding from interest rates, foreign exchange rates, commodities and energy to even weather and other risks. Treasurers value the range of instruments and providers that are available to them, and the flexibility to tailor a derivative to their exact requirements to achieve a good match for hedging purposes with the underlying business risk being hedged and how it is to be accounted. The majority of activity by value is in interest rate and FX derivatives.

Treasurers are also responsible for the borrowing activity in their companies and can be issuers of borrowing instruments such as bonds and bank loans. On the asset side they will deal with the investment of cash, mainly short term liquidity, but sometimes in longer term or more complex instruments when there is a structural need for investments or via

their pension funds or where a company wants to hold liquidity in order not be dependent on banks or bond markets at any particular time.

Our members will often have a very specific interest in a relatively narrow range of instruments but the size of transactions can be very significant. For example a bond issue may trigger the need to execute a 10 year currency swap to change the issue (say USD 500m or 1bn) currency back into the currency required in the business. Such large transactions may not occur that frequently but on the other hand there may be numerous smaller FX transactions to hedge normal sales and purchases and these may add up to a large sum.

In this context the ACT is commenting on a selection of the most relevant questions raised in your consultation.

Specific responses

Developments in market structures

> (8) **What is your opinion of the introduction of a requirement that all clearing eligible and sufficiently liquid derivatives should trade exclusively on regulated markets, MTFs, or organised trading facilities satisfying the conditions above? Please explain the reasons for your views.**

Proposals for a Regulation of OTC derivatives are already in train in Europe (EMIR). Within that regulation it is recognised that non-financial counterparties have very valid reasons not to be forced into clearing. Partly, this is because such entities are unlikely to be a cause of systemic risk and they are less correlated than financial services sector companies. Partly it is because to do so would create an enormous drain on company funding and liquidity to the detriment of the individual company and, overall, to the real economy. There are appropriate exemptions from clearing provided in EMIR.

In the same way it would be appropriate for any changes to the MiFID framework to have corresponding carve outs for non-financial companies.

Many derivative instruments used by non-financial companies are highly tailored and not suitable for central clearing or exchange trading, but even where an instrument may be sufficiently standardised to be clearing eligible companies may prefer to deal OTC with their banks. Smaller companies in particular are unlikely to have the skills and experience to be able to make special arrangements to deal through an exchange, preferring the assistance and comfort of dealing with their house bank. Banks provide a service that customers are willing to pay reasonably for.

If non-financial companies were required put their derivative transactions through an exchange, the impact would be counterproductive as regards promoting deeper, more integrated and liquid financial markets. It would, rather, restrict the practical hedging techniques available to companies that need to create hedges matched to their exact requirements. Indeed some may be forced to stop hedging and so introduce a new risk into the commercial systems. Non-financial companies are not in a position to create the necessary matching by undertaking complicated hedging strategies using combinations of exchange traded contracts and continuous adjustments.

Those companies that did not abandon hedging but continued via exchange trading and were forced to post collateral would have to carry a new liquidity risk – potentially destabilising them. Financial institutions fulfil a useful purpose for the business world in that they are able to take, limit and manage risks including the consequent liquidity risk

and the credit risk of their counterparty. This is a service for which companies reasonably expect to pay appropriately, usually in the spread applied to transactions.

Any changes to the MiFID should recognise the needs of non-financial companies both large and small.

Pre- and post-trade transparency

Non-equity markets

(37) **What is your opinion on the suggested modification to the MiFID framework directive in terms of scope of instruments and content of overarching transparency requirements? Please explain the reasons for your views.**

(38) **What is your opinion about the precise pre-trade information that regulated markets, MTFs and organised trading facilities as per section 2.2.3 above would have to publish on non-equity instruments traded on their system? Please be specific in terms of asset-class and nature of the trading system (e.g. order or quote driven).**

(39) **What is your opinion about applying requirements to investment firms executing trades OTC to ensure that their quotes are accessible to a large number of investors, reflect a price which is not too far from market value for comparable or identical instrument traded on organised venues, and are binding below a certain transaction size? Please indicate what transaction size would be appropriate for the various asset classes.**

(40) **In view of calibrating the exact post-trade transparency obligations for each asset class and type, what is your opinion of the suggested parameters, namely that the regime be transaction-based, and predicated on a set of thresholds by transaction size? Please explain the reasons for your views.**

(41) **What is your opinion about factoring in another measure besides transaction size to account for liquidity? What is your opinion about whether a specific additional factor (e.g. issuance size, frequency of trading) could be considered for determining when the regime or a threshold applies? Please justify.**

Your consultation paper seeks to extend the pre- and post-trade transparency arrangements for equity markets into non-equity markets. This is, we believe, a category error. By their nature markets for bonds and derivatives are very different from equities.

Bond markets appear relatively similar in that a defined instrument exists and within one issue all the bonds are standardised. However the while a company may have one class of equity traded it may have multiple bonds in issue with different maturities, currencies, levels of security, rankings in insolvency and perhaps different detailed terms and conditions and of course different issue sizes and interest rates. The trading activity and liquidity in corporate bonds is generally fairly low. This is partly due to the fragmented nature of issues and partly due to the "buy and hold to maturity" practice of investors.

When it comes to derivatives again there can be a diversity and lack of trading which will be most marked in OTC derivatives that are not clearing eligible. As a point of detail the

MiFID proposal seeks to be applicable to all derivatives reported to trade repositories under Article 6(1) of the OTC derivatives regulation. That clause may well end up being altered so that *all derivatives* regardless of counterparties or size have to be reported. We assume it would not be the intention to make any price transparency that broad in scope.

The ACT supports open liquid, transparent and honest markets[1] and so would normally welcome increased competiveness through improved flow of information to a market. In the case of bond markets binding pre-trade quotes would not necessarily be representative of the market given the shortage of liquidity, so that any emphasis should rather be on post-trade reporting.

In the case of non-financial companies using OTC derivatives, any pre- or post-trade information is unlikely to be that helpful to users given its tailored nature. Deals may be small, or of reasonable dealing size or exceptionally large, for unusual maturities, have specific tailored cash flow profiles and be priced accordingly. Price quotes also depend on the credit risk of the company dealing. True comparability would be impossible. Understanding even post-trade information on OTC derivatives would require complex analysis and interpolation such that its provision would actually distort the market in favour of the more sophisticated quants to the detriment of less experienced or resourced users.

Pricing indications already exist from Bloomberg and Reuters and others and from various brokers or dealing platforms from which companies can adjust for their own circumstances. Ultimately companies have the ability to seek competitive dealing quotes specific to their need that will be more useful than some vast database of pre- and post-trade information.

Investor protection and the provision of investment services

Execution only services

> (87) **What is your opinion of the suggested modifications of certain categories of instruments (notably shares, money market instruments, bonds and securitised debt), in the context of so-called "execution only" services? Please explain the reasons for your views.**
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> (88) **What is your opinion about the exclusion of the provision of "execution-only" services when the ancillary service of granting credits or loans to the client (Annex I, section B (2) of MiFID) is also provided? Please explain the reasons for your views.**
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> (89) **Do you consider that all or some UCITS could be excluded from the list of non-complex financial instruments? In the case of a partial exclusion of**

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[1] Extract from ACT Policy & Technical manifesto (http://www.treasurers.org/technical/manifesto):
The ACT takes the following as basic premises

1. Open, liquid, transparent and honest markets are in the interests of all companies involved in those markets in any way and of society at large.
2. It is important that market infrastructure, payment systems, etc. take account of corporate client needs as well as financial service industry convenience.
3. Regulation commonly represents a barrier to entry, restricts competition and innovation and increases costs. It should thus normally only be used as a last resort where there is evidence of an actual or potential market failure or in quasi-monopoly areas where competition is insufficient, industry codes etc. have failed and where the public good from regulation manifestly exceeds the costs it engenders.
4. Where regulation is to be applied it should be with a bias towards light-touch- and principles-based regulation to lower costs and preserve as much flexibility as possible.

certain UCITS, what criteria could be adopted to identify more complex UCITS within the overall population of UCITS? Please explain the reasons for your views.

(90) **Do you consider that, in the light of the intrinsic complexity of investment services, the "execution-only" regime should be abolished? Please explain the reasons for your views.**

It is good that investors are given some protection against unscrupulous behaviour by financial intermediaries but equally a customer of any product, financial or otherwise, should understand the ancient concept of "Caveat emptor" (let the buyer beware). To absolve one section of society form taking responsibility for its own actions inevitably throws the burden of responsibility, and liability, onto another section. There is then the question of achieving the appropriate balance bearing in mind fairness, the ability of the parties to exercise their respective responsibilities, the cost burdens on the parties and the consequences on the parties and society generally of failures.

Assuming that the nature of execution only services and the lack of appropriateness checks is made very clear at the outset it seems unnecessary to limit the freedom of investors to opt for the level of service they desire. It may be appropriate to repeat this information from time to time to deal with staff turnover in clients. The abolition of execution only services would automatically force some customers to bear the costs of a standard of service they may not want.

Execution only service is available for non-complex instruments. The clarifications and limitations you are proposing as to what instruments are non-complex seem reasonable, with the exception that shares in collective investment undertakings may well be non-complex. We suggest that this latter category could be refined further in the same way that you are proposing to refine the categorisation of UCITS.

Investment advice

(94) **What is your opinion about introducing an obligation for intermediaries providing advice to keep the situation of clients and financial instruments under review in order to confirm the continued suitability of the investments? Do you consider this obligation be limited to longer term investments? Do you consider this could be applied to all situations where advice has been provided or could the intermediary maintain the possibility not to offer this additional service? Please explain the reasons for your views.**

Clients seeking advice may well differ in the level of service they require and are prepared to pay for. We accept that suitability may change with time so that subsequent reviews may be sensible but see no reason to require all clients to take this level of service. As with much of the investor protections, a suitable health warning that on-going suitability assessments are not being provided would be a good compromise protection. It may be appropriate to repeat these warnings from time to time to acknowledge staff turnover in clients.

Classification of clients

(104) **What is your opinion about retaining the current client classification regime in its general approach involving three categories of clients (eligible**

counterparties, professional and retail clients)? Please explain the reasons for your views.

(105) **What are your suggestions for modification in the following areas:**

a) Introduce, for eligible counterparties, the high level principle to act honestly, fairly and professionally and the obligation to be fair, clear and not misleading when informing the client;

b) Introduce some limitations in the eligible counterparties regime. Limitations may refer to entities covered (such as non-financial undertakings and/or certain financial institutions) or financial instruments traded (such as asset backed securities and nonstandard OTC derivatives); and/or

c) Clarify the list of eligible counterparties and professional clients per se in order to exclude local public authorities/municipalities? Please explain the reasons for your views.

(106) **Do you consider that the current presumption covering the professional clients' knowledge and experience, for the purpose of the appropriateness and suitability test, could be retained? Please explain the reasons for your views.**

We welcome the clarification that the framework directive's principles to act honestly, fairly and professionally and the obligation to be fair, clear and not misleading also apply in the relationship with eligible counterparties. This is a very important point, fundamental to market quality.

At present, for the appropriateness assessment, the client's experience and knowledge relevant to the product of service offered is deemed met for professional clients and is not required for eligible clients.

For the suitability assessment for both professional and eligible clients it can be assumed that experience and knowledge is met, but the client's financial situation and investment objectives still need to be covered.

This gradation of protections and requirements gives a series of different levels. In proposing to benefit certain types of entity with further protection by precluding them from the eligible category you are creating a disbenefit to those within that type of entity that may want eligible status. At present before dealing with its customer as an elective eligible counterparty, an investment firm is required to obtain positive confirmation from that customer that it understands that it will be treated in that way. Surely this is the right degree of protection or heath warning.

A per se professional client does not benefit from the obligation to be given a statement of the "relevant conditions for the categorisation of clients" so it might avoid confusion if a change could be made to require this information at original classification. MiFID contains a complex set of rules so it is difficult for client to understand full the implications of each categorisation. Any additional clarification and straight forward explanations that can be given at the outset would be helpful and it may be that the form of those explanations could be better presented.

For treasurers in non-financial companies the ACT issued a briefing note[2] which attempted to clarify how the various rules and protections apply to different client categorisations so as to help companies decide the best level for their own circumstances. We reproduce an extract from that guide in the appendix.

Accordingly we see no reason to modify the classification of clients save for applying the general principle to act honestly etc., and providing per se professional clients with the "relevant conditions for the categorisation of clients".

Underwriting and placement

> (124) **Do you consider that some aspects of the provision of underwriting and placing could be specified in the implementing legislation? Do you consider that the areas mentioned above (conflicts of interest, general organisational requirements, requirements concerning the allotment process) are the appropriate ones? Please explain the reasons for your views.**

On issuing securities (equity or bonds) the intermediary is engaged by the issuer but at the same time has an interest in maintaining a good relationship with the investors. The issuer may be issuing relatively infrequently whereas the intermediary has the likelihood of regular repeat business with the investors. The sale and distribution of securities at a lower price makes them more attractive to investors and easier for the intermediary to sell, whereas the issuer will prefer a sale at the highest practical price. Although real circumstances will be more complex with far more considerations this does illustrate the inherent conflict of interests for the intermediary in the issue process. The conduct of business rules around new issues should be mindful of this and ensure steps are taken to minimise conflicts of interest and that those remaining are well managed.

The flow of information about the issuer is well catered for in legislation and specific market rules but the information on the issue processes and procedures is perhaps not so well covered. Better information as to the issuer's and intermediary's intentions could be provided at the outset.

The processes for underwriting and for placings are generally working but we accept that research may indicate that some refinements in the areas mentioned in the paper so that some further requirements could be considered in the revised directive.

Any changes should not impair the ability of the issuer to determine to whom allocations are made. Issuers value the flexibility they have as regards setting the price and making allocations so that they can achieve the outcome they desire - a full take up and successful issue. We note that the proposal is to consider certain aspects of underwriting and placings in the implementing legislation. We would be concerned if this route were to be used to introduce fine detail without consultation that might nonetheless have a significant impact. For example, if the issuer is seeking buy and hold investors there should be no obligation to allocate pro rata the applications if the issuer feels that the trading behaviour some investors would be destabilising.

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[2] The Association of Corporate Treasurers, Briefing note: MiFID (Markets in Financial Instruments Directive) for Corporate Treasurers http://www.treasurers.org/node/2937

Appendix

Extract from The Association of Corporate Treasurers, Briefing note: MiFID (Markets in Financial Instruments Directive) for Corporate Treasurers
http://www.treasurers.org/node/2937

Table : Client categorisation: criteria and consequences

	RETAIL CLIENT	PROFESSIONAL CLIENT	
			ELIGIBLE CONTERPARTY
Category criteria	Retail is the default category	Based on the clients expertise, experience and knowledge and if they meet two of: has carried out at least 10 significant transactions per quarter over the previous 4 quarters holds cash and financial instruments over EUR 500,000 has worked or currently works in the financial sector **OR** Is a per se professional client which includes a high net worth company	For UK is a high net worth company which mean they meets two of: Balance sheet total of EUR 20m Net turnover of EUR 40m Own funds of EUR 2m **OR** is not an individual and has requested ECP status (an elective ECP) **OR** Is a per se ECP Note: Rules may vary with home state
Flexibility between categories	Opt up allowed, instrument by instrument	Opt down to retail allowed on request Opt up allowed (but not for an individual) depending on Member State	Opt down to professional or retail allowed
Pre-dealing general information required	Yes	Yes (but not if a professional client under the transitional rules)	Not required
Best execution required	Yes	Yes	Not required
Appropriateness required (applies to services other than portfolio management or investment advice or execution-only services in non-complex instruments) *(Appropriateness covers experience and knowledge relevant to the product of service offered)*	Yes	Deemed met	Not required
Suitability required Applies to investment advice and portfolio management *(Suitability covers experience and knowledge relevant to the product of service offered and consideration of the client's financial situation.)*	Yes	Can be assumed that experience and knowledge is met. Still need to cover client's financial situation and investment objectives.	

The Association of Corporate Treasurers

The Association of Corporate Treasurers (ACT) is the leading professional body for international treasury providing the widest scope of benchmark qualifications for those working in treasury, risk and corporate finance. Membership is by examination. We define standards, promote best practice and support continuing professional development. We are the professional voice of corporate treasury, representing our members.

Our 4,000 members work widely in companies of all sizes through industry, commerce professional service firms.

For further information visit www.treasurers.org

Guidelines about our approach to policy and technical matters are available at http://www.treasurers.org/technical/manifesto.

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