

ABI/AMTE/BVI Conference - Keynote address

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Ladies and Gentlemen,

It is a great pleasure and a privilege for me to be participating in this conference. I would like to express my thanks to ABI and AMTE for their invitation to present a regulator's views as an introduction to this panel on the efficiency of bond markets. I will start with a few comments on primary markets and end by the current topic of transparency in the secondary market.

Since the beginning of the 90s, the implementation of the Maastricht treaty and the arrival of the euro have contributed to the opening up of capital markets. The number of investors and issuers has quickly increased, and facilitated the emergence of a new debt market which had previously been dominated by government and bank issuances. As the supply of government paper has temporarily dried up, demand has been directed towards a growing volume of issuance by European corporates. Corporate issuers have been clearly welcomed by investors looking for new names and attractive remunerations, especially within the context of a low interest rate environment. At the same time, banks themselves have been under pressure to improve their return on equity and lower their corporate exposure. Consequently, the European debt market has burgeoned into a large number of directions, creating a much more complex but rewarding set of opportunities for investors, issuers and arrangers.

In this context, the recent report published by the AMTE has identified three main areas of concern and therefore sources of improvement:

- The availability of information and the way of ensuring more timely distribution of prospectus material,
- The need to address ambiguities in terms and conditions,
- The need to improve clarity in covenant language, with a particular focus on "takeover protection" and "negative pledge" clauses.

These are legitimate issues, that both the investors' and the regulators' communities in Europe should put on their common agenda in the coming months.

To illustrate that view, I would like first to highlight the key elements of the three European directives adopted during the past few years, and which deal with capital markets. To me, these directives have set the first conditions of an adequate market environment, especially in terms of equal, easy and quick access to information and are therefore a sound basis for further developments.

As a first principle, the Prospectus directive provides for the publication of a document in the case of all public offers. The prospectus shall contain all information which, according to the particular nature of the issuer and of the securities offered to the public, is necessary to enable investors to make an informed assessment of the issuer's financial situation and of the rights attaching to such securities. To be more specific it is our conclusion that the content of the prospectus must give a particularly clear information to an investor about the legal terms and conditions of the notes to be issued.

I hope today you don't expect me to talk about the details of these provisions, the meaning of "become payable" or "triggering event", and to suggest new wordings with you. As you have said in your report, the freedom of contract is a key element, so long as it is clear and understandable for all market participants and in compliance with existing laws and regulations.

However we, as regulators, also have to take into account the new nature of the markets. Over the recent years, while the terms and conditions of the bonds issued

by banks were well known and recurrent, the terms and conditions of non-financial issues have been more diversified, depending on the issuers' legal structures and financial situations. This trend has been amplified by the fact that the credit quality of issuers – previously limited mainly to high-quality, large issuers or retail-oriented “household names” –has also been diversifying. The growth of the high yield markets has been remarkable, even though it started from a very low base. The current trend of leveraged buyouts, as well as mergers and acquisitions, may also substantially impact the bond market. Finally, the decisions by some issuers to sell or buy significant assets on a more frequent basis, especially among investment grade corporates and banks, is a potential concern, as their debt instruments have traditionally contained little in the way of protection for investors other than a negative pledge and pari passu clause.

In that respect, the clarity of information disclosed in the documents regarding all events which may affect the issuer's capacity to meet its obligations during the life of the bonds, are key elements for a proper functioning of the bond market and investor confidence. The presence of additional covenants in bond issues may indeed change the risk and/or payment profile of the securities. A clear and fair understanding of the characteristics of these covenants might consequently have a real impact on the behavior of the bonds in the secondary market.

According to an recent bank study, about one in two new investment grade issuers is now using a change of control clause, compared with 7% prior to April 2005. These trends are both very recent, but also pretty dramatic in terms of potential impact for all parties.

The capacity of investors to manage these evolutions is still diverse though. The main and most sizeable institutional investors have obviously been aware of the meaning of the legal wording or at least can rely on their own legal and financial department to make up their own minds about the securities they want to invest in. Other more occasional investors, or investors with less capacity to deal with legal issues, may have more difficulties analyzing the characteristics of the terms and conditions, the quality of the covenants and the rationale behind them. In addition, investors have not always been put on an equal footing in terms of accessibility of

information in an appropriate and timely manner, especially when investors are not located in the same country as the issuer. If the introduction of euro and the increasing harmonization of rules have given the possibility for managers to invest more aggressively into foreign securities, investors may still have difficulties to deal with the law applicable to the securities.

I therefore fully support all initiatives which could lead to further improvement of the market functioning in that area and I particularly welcome self regulatory initiatives in that direction. Market participants are certainly best placed to deal pragmatically with such issues. As an example of such initiatives, I would like to mention the standards that the French bond association produced a few years ago with regards to the terms and conditions of securities for retail investors. They are still in practice today. Such example seems worth following.

Regarding now the financial content of the prospectus, I am still not convinced by the distinction in terms of disclosure established by the Prospectus directive between debt and equity. In light of the AMTE report, I consider for example that the capitalization and indebtedness table should be systematically included into a debt prospectus with a clear distinction between guaranteed/unguaranteed or secured/unsecured indebtedness. It should be a first step to help investors appreciate the level of debt compared with the company's equity capital. In this area, one should welcome the initiative launched by IOSCO to establish "International debt disclosure Principles", a draft of which has already been published for consultation at the beginning of 2006. These IOSCO principles are a clear incentive to disclose information about the issuer's short-term and long-term liquidity, including the issuer's internal and external sources of liquidity. Subject to further discussion at IOSCO level, this should cover any material restrictions on all sources of liquidity and particularly bank covenants. In that respect, the French AMF has always insisted on the importance for issuers to incorporate the necessary information about material bank covenants in any prospectus. I can only support any international evolution towards such a practice.

Finally I would like to raise the question of the risk factors. Most of the time, as you know, this paragraph on risks contains an extensive display of legal wording which sometimes have no direct relation with the issue or the issuer. As a result, the key features of the issue and the issuer can end up being swamped by this type of provisions. I would consequently advocate that we work jointly on the relevance and the adequacy of the risks that are presented in this chapter, so that they can become more precise and more informative to investors.

Now let's come to the Market Abuse and Transparency directives.

During the life of the securities, debt issuers have first to comply with the Market Abuse directive on insider dealing and manipulation. This directive aims at ensuring a prompt and fair disclosure of information to the public and enhancing market integrity. In that respect, I would like to point out the fact that inside information is not limited to the issuer's financial condition, but also includes all information concerning the securities themselves. "Inside information" means any information of a precise nature which has not been made public, and which, if it were made public, would be likely to have a significant effect on the prices of the financial instruments or of related derivatives. There have certainly been several sources of concern in the international bond market lately from that point of view. The AMF is fully committed to increase the level of surveillance in the markets at the European level, especially in the area where there are the highest risks, *i.e.* the credit market, where certain players have substantial conflicts of interests to manage.

The implementation of the Transparency directive at the beginning of next year will again set new information standards. In particular it requires half yearly financial reports for bond issuers, so long as the denomination per unit is below 50,000 euros.

I would also like to draw your attention to the fact that the Transparency directive will clearly favor a better and non discriminatory access to information through new officially appointed mechanisms. This central storage system of regulated information is to be implemented in the coming months. The European Commission will soon publish a draft relating to the architecture for this EU storage network and the minimum quality standards required from these mechanisms.

This is another step towards a better level of transparency, at least for retail bond issues. We will assess the impact of this directive over the coming years. Market professionals should inform the regulators if they feel there is a need for further effort, including in the area of wholesale transactions.

Finally the Transparency directive reaffirms the need for the issuer of debt securities to ensure that all bondholders ranking *pari passu* are given equal treatment in respect of all the rights attaching to those securities, especially when it comes to exercising their voting rights. In a well known book called "How to negotiate Eurocurrency loan agreements," Mr. Lee C. Buchheit gives the following definition of the *pari passu* clause: "this is a charming clause. It is short, obscure and sports a bit of Latin; all characteristics that lawyers find endearing". Even if this definition might be a bit exaggerated, regulators have tried during the past few years and still try to create a market environment which makes this definition less appropriate. We favor all market initiatives towards better and constant implementation of the principles of the directive. Investors on their side might also give more attention to bondholders' meetings and try to be more actively involved in these meetings. It is indeed in the interest of all market participants to develop practices which serve investors and borrowers satisfactorily under a range of different conditions, and thence help to support the broader economy.

You will have understood that many of my previous remarks may be relevant both for the primary and the secondary markets, but I will more specifically devote the last part of my speech to the latter.

Last year, at the ISMA conference, where I had been invited to speak, I warned the audience that, as a French regulator, I was probably not the best specialist to address these complex issues in front of a most sophisticated audience. This warning is certainly still valid today, both as regard the ever increasing complexity of the issues and the even greater sophistication of the audience! Since then, I have certainly taken a great interest in a number of studies, consultation papers and academic work produced or released over the last 18 months on the secondary bond markets. You will probably not be surprised if I make a special mention of the study of

the Centre for Economic Policy Research (CEPR) on the “European Corporate Bond Markets: transparency, liquidity, efficiency”. First because it was co-sponsored by the ABI, second because the sponsors of this study were adventurous enough to assign it to a French academic, Bruno Biais, and third, because one of its most interesting findings is that the UK should join the Euro!

Various elements have contributed to this interest in the functioning of the European bond market and will likely continue to do so over the next few months.

- In 2004, IOSCO produced a report and recommendations on the transparency of the corporate bond market. It is currently working on its update in the wake of the Parmalat affair. It has proved a useful opportunity for the jurisdictions involved to reassess the relevance of previous recommendations in this area.

- The implementation of TRACE in the US has triggered interest in Europe on if and how similar trade reporting and publication mechanisms could usefully be implemented for our own bond market. This has been all the more pregnant that the first academic papers on TRACE’s impact in terms of effective spreads and trading volume, have now become available;

- Finally, and probably most importantly from an operational standpoint, the final adoption of MIFID level 2 measures, including the details in the pre and post trade requirements for shares, has now set the scene. The next item on the agenda is the report to be published by the European Commission by October 2007 on the possible extension of the scope of the Directive to pre and post trade transparency obligations for transactions in the bond markets.

So, where do we go from here? As a starting point and as a matter of principle, bond markets and their participants should be committed to integrity, fairness and efficiency and I would not expect anyone to challenge those very key components of any capital markets. Rather, the question on the table at the moment is to which extent trade transparency can contribute to the enhancement of these components, or whether the unique characteristics of bonds and bond trading require a totally different approach to transparency as a regulatory tool.

In its call for evidence, the Commission very usefully listed some policy rationale for transparency in the area of investor protection and market efficiency (information asymmetries, best execution, mark to market valuation of assets). The AMF fully shares and supports those views.

Some respondents have challenged the need for investor protection, based on the fact that there is little direct retail participation in bond markets in Europe. This is a fact I would not contest, although there is still some diversity in this area among European countries. What I would rather criticize is these respondents' conclusion. According to them, as there is no direct retail participation and participants in the bond market are able to fend for themselves, the issue of investor protection would not be relevant. On the contrary our experience is that between a retail investor and an eligible counterparty, there is a wide array of investors who may not be as sophisticated as their sell-side counterparties and for which the Commission's policy rationale would definitely be valid.

On price information asymmetries, I was interested reading in the ICMA response to the Commission's paper that "the bond market model around which most dealers are organised does not suffer from the inefficiencies and informational asymmetries which the literature on cash equity markets assumes are inherent in diversified structures not based upon central limit order book models". But at the same time, the ABI answer to the FSA consultation paper mentioned that "the willingness of certain investors to exploit information asymmetry was seen as a fundamental aspect of the bond market" and that it was the reason why these participants were opposing additional transparency. I trust that the financial community can come to a reasonable conclusion on the existence of price asymmetries and therefore on the obvious need for a minimal transparency in the area of bond prices.

Another issue that might be worth mentioning here is the link between best execution, fair value and transparency. Best execution requirements under MIFID apply to all financial instruments and to all investors except eligible counterparties. It remains to be seen how many investors on the buy-side will choose to opt out, when they are eligible by nature. Similarly, fair value in the IFRS is a wide concept that will

need full and consistent application across markets and existing instruments. As opposed to some, we do see a close link between transparency, fair value and best execution and it would therefore make sense for prices to be accessible on a wider and more harmonised basis in Europe. This should not be limited to fund managers, but also for the so called “professional” investors who do not necessarily have easy access to such information. Once published the information would allow these same investors to make a more accurate assessment of the quality of order execution they have received. It would also provide intermediaries with a useful frame of reference for establishing their order execution policies and, where requested to do so, for demonstrating they have fulfilled their best execution obligation.

I have been reading responses to the various consultations and listening to the industry, both from the buy-side and the sell-side. I understand that our point of convergence on a possible way forward is in the area of **post trade transparency**. This was suggested by the CEPR’s report and supported, among others, by most respondents of the ABI constituency to the FSA’s Consultation Paper. They all inclined to the view that, subject to appropriate safeguards maintaining the balance between liquidity and transparency, greater post trade transparency would be beneficial.

Achieving that right balance, setting up the appropriate framework governing the trade information to be published: price/spreads, trade by trade or aggregated data, deferrals of publication, is not an easy task though. And we certainly welcome an industry-led proposal in this area. We take note of ICMA’s announcement that they were working on it with their members and expect to come out with a proposal early 2007. We look forward to the outcome of the process, as we look forward to working with all market players on these issues, ahead of the release of the Commission’s report. MIFID provides the industry with a real opportunity to come up with new initiatives and to provide appropriate responses in this area. Should it be the case, the questions remain open as to whether an industry code of conduct for post-trade transparency would be sufficient to ensure an harmonised level playing field across Europe, or whether they would be a need for some kind of regulatory intervention or endorsement to ensure consistent and effective implementation of the industry initiative. This is an issue up for discussion.

A similar debate has taken place in the US around the benefit of post trade transparency, the actual impact of the implementation of TRACE on spreads, and the extent of a mandatory system. As a potential solution to the same question in Europe, I would be inclined to invite the industry and academics to work on a real-life test, as they did in the US. We could for example breakdown a significant sample of European corporate bonds with similar characteristics, in two groups. One would be traded under post trade transparency requirements and the other group, “the blind one”, remain subject to current trade practices. Such a test would certainly be a helpful in the future discussions we will hold with the Commission, as we should not rush into one or the other option without an actual experiment of the choice to be made.

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Ladies and Gentlemen, bond markets have been developing very rapidly over the last few years and it is likely they will continue to do so, leading both regulators and market participants towards renewed challenges. Will there be further changes to the bond markets with new competition between players and additional innovation? Will there be a shift towards electronic execution systems? Will investors insist on the need for more transparency both on the primary and secondary markets and the development of new tools to compare execution quality across trading venues? Whatever the answers to these questions, I am confident that this conference will demonstrate that regulators and market practitioners share a common interest in further developing the transparency, efficiency and integrity of the bond markets through an appropriate balance between regulation and industry-led initiatives. We look forward to it.

Thank you.