SWEDISH SECURITIES DEALERS ASSOCIATION

8 April 2015

MARKET MAKING
KEY FOR EFFICIENT MARKETS THAT FINANCE ECONOMIC ACTIVITY

Market making is too often misunderstood owing to its technical nature. But it is a key issue for both primary and secondary markets in three major asset classes: equities, bonds and derivatives, both on organised platforms and over the counter.

- Market making is a crucial tool for financing governments and corporates.

  One outcome of the capital adequacy standards adopted in the aftermath of the financial crisis is that the funding model for the European economy is increasingly slanted towards market financing instead of bank credit. That companies are now turning increasingly to bond markets is enlightening in this respect.

  True, fund raising takes place on the primary market, but the related pricing conditions (i.e. the cost of capital) depend heavily on the efficiency of the secondary market. When investors calculate the risk premium they demand for investing in a bond, they pay particularly close attention to the liquidity of the secondary market. It is this factor that determines whether they can sell their holding quickly, when they choose and at a price that adequately reflects market fundamentals. Investors buying assets in the secondary market make the same calculation.

  As such, market making is key to ensuring a liquid secondary market in equity and debt. Contrary to common belief, liquidity, meaning when buying and selling interests meet, does not occur spontaneously. In consequence, the market maker's role is to create a liquidity bridge between the investors by using its balance sheet to execute transactions on its own account.

  - The secondary sovereign and corporate bond markets operate almost entirely as a result of market makers. Accordingly, many governments have appointed market makers as primary dealers to improve the management of their sovereign debt.
  - The secondary equity market is naturally more liquid and organised around a model based on matching buyer and seller interests. But this market, too, needs market makers to function efficiently. Not only do market makers ensure that trading platforms operate smoothly, they are the only ones capable of handling trades that are too big to be absorbed naturally.

- Market making is also essential part of a risk hedging service, both for economic agents (currency risk, interest rate risk, commodity price risk, etc.) and for investors (interest rate and portfolio risk). As with equity and bond markets, this is done by supplying liquidity to those wanting to buy or sell. But it is also made possible by market makers' ability to tailor their products to the specific risk management needs of these market participants.

Market making involves proprietary activity by financial institutions and thus is often grouped with purely speculative activities, which have become highly controversial. And yet, when done for the benefit of clients or the market itself, it is unarguably legitimate.

Furthermore, in recent financial reforms (a large number of countries recognise the importance of market making with respect to the service it provides to issuers and investors, such as in the French financial transaction tax.

As these same issues come under discussion at European level, it is vital that market making be recognised as useful, both for clients and for markets, in order to ensure that an activity which serves the interests of issuers and investors does not disappear. As such, it is important for these discussions to be based on a clear vision of market making and all of its various aspects, from the inventory building stage to risk management using hedging transactions, on trading platforms as well as over the counter. That is why AMAFI, AMF, ASSOSIM, bwf and SSDA have drawn up the following annex.

Amafi — Association française des marchés financiers — LES PROFESSIONNELS DE LA BOURSE ET DE LA FINANCE

Asociación de Mercados Financieros

ASSOSIM® Associazione Italiana Intermediari Mobiliari

bwf Bundesverband der Wertpapierfirmen

SWEDISH SECURITIES DEALERS ASSOCIATION

ANNEX

MARKET MAKING: PRACTICAL IMPLICATIONS AND CHARACTERISTICS

MARKET MAKING IS USEFUL TO THE ECONOMY

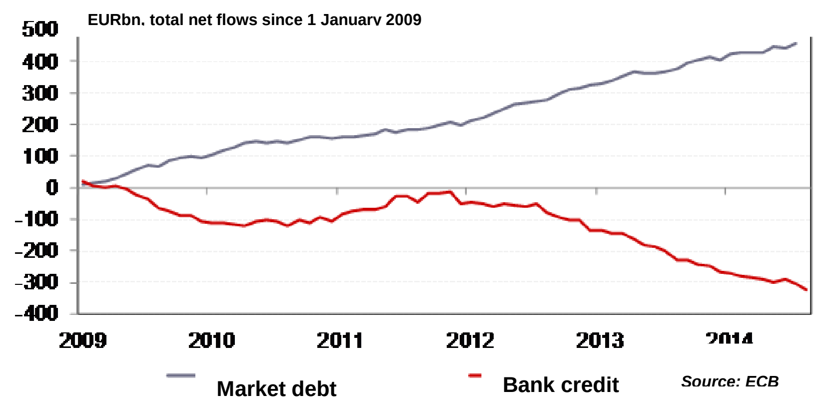
Market making is performed by financial institutions to help the economy function properly. Much more than a mere profit-seeking activity, it helps governments and corporates to meet their financing needs and also enables them, along with investors, to hedge risk.

MARKET MAKING, A TOOL FOR FINANCING GOVERNMENTS AND FIRMS

A financing model that is shifting increasingly towards the market

In Europe generally the economic financing model is changing radically. Owing to the capital adequacy standards put in place or being drafted in response to the excesses of the financial crisis, the system of financing the European economy is starting to look much more like the one in the USA, where nearly 80% of financing is disintermediated. The change is already under way, with firms realising that they need to diversify their funding sources. Developments on the bond market – a direct substitute for bank credit – are indicative of the underlying trend: European non-financial companies' level of outstanding debt securities increased by more than 50 % between 2008 and 2014.

EURO ZONE: NON-FINANCIAL COMPANY DEBT



The same concern can be seen at the European level, prompting the Capital Markets Union project launched by the new European Commission in summer 2014[1].

[1] Speaking to the European Parliament on 15 July, Jean-Claude Juncker said, "Over time, I believe we should complement the new European rules for banks with a Capital Markets Union. To improve the financing of our economy, we should further develop and integrate capital markets. This would cut the cost of raising capital, notably for SMEs, and help reduce our very high dependence on bank funding. This would also increase the attractiveness of Europe as a place to invest."

No separating the secondary and primary markets

For market financing to work at the lowest cost to firms, primary market investors need to know that the secondary market is efficient, i.e. that it is liquid enough for buyers and sellers to trade as smoothly as possible. Investors can never be certain of holding primary issues to maturity (especially since equity can be "perpetual"). Accordingly, their appetite, as well as the prices of the assets they invest in, depends directly on the ease of finding potential buyers when they want to divest. The rationale is the same for secondary market buyers, who will later find themselves in the same position. Thus, secondary market liquidity is what allows firms, governments and local authorities to obtain financing at the best possible cost, without having to factor in an exorbitant risk premium.

Secondary market liquidity is not just important for investors individually; it is also a key ingredient in the market's price-discovery function. In other words, the larger the number of trades, the greater the likelihood that the resulting prices will reflect market fundamentals.

These market-determined prices allow entities, chiefly firms, intent on carrying out their plans to see the value-enhancing effects of their assets and strategies, set their cost of capital (the price at which they can raise fresh funds), and determine the price at which they might make an acquisition or even become a take-over target. That same price also allows small investors to appreciate the value of their holdings.

Numerous factors influence market liquidity. The size of the issue, naturally, but also whether intermediaries play an active role in "distributing" the issue to investor clients[2], whether there is a long-term investor relations strategy, and whether a liquidity contract has been arranged (in an order-driven market)[3]. But more importantly, market making plays a special role that must not be underestimated.

Market making contributes liquidity to equity and debt securities markets

The equity and debt markets (i.e. shares and bonds) are the ones to consider when it comes to financing governments and firms. Market making is pivotal to the orderly operation of bond markets, and also plays an important role in equity markets. In Europe, the number of unique debt issues[4] is tiny compared with equities, at around 150,000 for the former and 7,000 for the latter.

<u>The secondary bond market for government and corporate securities operates almost entirely through market making.</u>

[2] Notably by publishing financial research: a recent study showed that there is a link between analyst coverage and cost of capital (<u>*The Real Effects of Financial Shocks: Evidence from Exogenous Changes in Analyst Coverage, F. Derrien and A. Kecskés, upcoming in Journal of Finance*</u>).

[3] In this respect, see for instance the AMAFI standard liquidity contract form (<u>*AMAFI / 09-21a and b*</u>).

[4] Meaning cases when the newly issued securities do not share characteristics with those already in circulation.

For an individual issuer, bond markets comprise multiple issues (called tranches), which usually have different characteristics, notably with respect to maturity and rate of interest, and so are not fungible. As a result, apart from a few government or corporate bonds, the inherent liquidity of each tranche is weak, especially outside the three key periods during which a material increase in liquidity is typically observed, i.e. the days and weeks following an issue, just prior to redemption, and whenever an event occurs that affects credit generally (a yield curve shift, for example) or the specific issuer (rating change, etc.).

Investors fall into one of three categories: those who can hold an asset from issuance to redemption; those who cannot but who know their investment horizon; and those who do not know how long they will hold the asset. The share of investors in the first category can vary. While it often depends on the product's life span and maturity, no investor can guarantee beforehand that he will never need to cash in the investment before it matures. Thus, even if they start out with a buy-and-hold strategy, all investors need to know that there is an active, liquid secondary market where they can cash in their holding if need be. This is especially true of professional investors, such as collective investment schemes, insurance companies, mutual insurers and pension funds, which account for the bulk of the bond market, since the regulations governing them either forbid them from holding more than a set portion of their assets in somewhat or completely illiquid securities, or require that they significantly increase the capital adequacy buffers related to ownership.

Without the ability to ensure secondary bond market liquidity, the financing of the economy would depend on just a handful of investors that are able to hold assets until maturity regardless of the circumstances. The result for issuers would be an immediate increase in their cost of capital: on the one hand, demand would decline because only a small number of investors would be interested in their issues; and on the other, investors would require a high risk premium to offset the lack of liquidity.

Primary dealers: market makers in the service of financing the government

Most countries recognise the usefulness and importance of market makers when it comes to their ability to ensure optimal financing conditions. When they issue debt, they do so via a group of banks known as primary or authorised dealers , whose rights and duties are laid out in a charter signed with the government. These dealers act as market makers, with the government selling the debt it issues exclusively to the institutions, which are then responsible for distributing the debt to investors under conditions stipulated in the charter.

Furthermore, the vital nature of this activity has been recognised, as discussions on separating certain activities within banks aimed solely at generating a profit for the bank's own account (regulated under the Barnier Act) have seen fit to include an exemption for activities related to sovereign debt.

However, there has been no explanation why a service that is vital to governments is any less so for firms, especially considering the market in their debt securities is generally less liquid.

This is why, in practice, for an issuer to contract with a financial institution to place its securities, the institution must pledge to ensure liquidity in the secondary market by making a market. In this respect, issuers – both firms[5] and governments – see market making as an essential part of good debt management. This is also why the ability to make a market is one of the essential criteria for obtaining primary dealer status.

The secondary market for equities is naturally more liquid and now largely based on an order-driven model in which buyers and sellers exchange information either permanently (continuous quotation) or at regular intervals (call auction). Nevertheless it cannot operate efficiently without market making.

[5] Research confirms this analysis: in the context of the debate surrounding banking separation, see notably *Market Making Under the Proposed Volcker Rule*, Report to the Securities Industry and Financial Markets Association; and Thakor, A.V. (2012) *The Economic Consequences of the Volcker Rule*, Center for Capital Markets Competitiveness, Summer.

This is firstly true for all transactions that exceed the market's natural absorption capacity, in other words, trades that exceed the typical market volume. By transferring risk to the market maker, the investor can know the trade price with certainty and without being exposed to the detrimental price movement, or market impact, that the trade will inevitably cause. But in addition to this individual advantage, the market maker is also working in the general interest, because its activity benefits the market as a whole. Both the community of other investors and, indirectly, the issuer are spared the consequences of the price shift caused by a sizeable transaction.

This is also true of the activity known as facilitation, whereby a financial institution belonging to one or more multilateral trading facilities helps clients execute their orders. In doing so, the institution supplies its clients, when they request it, with liquidity over and above what is immediately present on the market by using its own account for the part of the order which, owing to its size, cannot be executed in short order on the platforms for which it is a member. The goal here is the same as above: prevent the market effect the client would otherwise have experienced.

Lastly, because buyers and sellers are not always present simultaneously to deal in equivalent quantities, particularly when a security has naturally weak liquidity, order-matching markets have been developing market making contracts for several years. These set the conditions under which market members undertake to intervene to buy or sell specified minimum quantities. With the liquidity they supply "to" the market on which they operate, market makers help investors either by creating a bid-ask spread or narrowing an existing one, ultimately reducing volatility.

MARKET MAKING IS A TOOL FOR HEDGING RISK AND OFFERING CUSTOMISED PRODUCTS

Market making also plays a widely acknowledged role in derivatives markets, which operate as indirect financing markets since they allow risk hedging by economic agents (currency risk, interest rate risk, commodity price risk, etc.) and investors (interest rate and portfolio risk). Furthermore, investors' ability to hedge their portfolio risk directly affects their appetite for investing in primary and secondary markets for equity and fixed income.

Market making is a response to the risk management needs of firms and investors

To minimise the repercussions of markets moving contrary to expectations, industrial and commercial firms today seek to hedge the risks inherent in their business activities, chiefly the risk of commodity price movements, currency risk and interest rate risk. For the same reasons, investors look for ways to hedge the risks related to their investment strategies. The challenge in both cases is to minimise the additional cost resulting from the hedge.

One of the most efficient ways to hedge these risks is to use derivatives. Sometimes, hedging can be done using the standardised products available on organised derivatives markets. But in many cases, those products do not adequately match a highly specific need, especially when the client is a corporate. As a result, financial institutions develop and "issue" products specially designed to cover their clients' specific risks.

Client-specific derivatives and active hedging management

Signing a contract with a client for a derivative that meets its specific hedging needs (currency risk, interest rate risk for an insurer, etc.) implies that the financial institution will actively manage the hedge.

This consists in making daily trades to adjust risk by buying or selling underlying instruments.

Without active management of the hedge, it would be impossible to offer clients protection under all circumstances, only when market levels allowed it. The result would be that clients would be forced to bear unwanted risks, leaving them subject to their economic costs.

However, by their very nature, the risks that a firm or an investor faces are not set in stone at a single point in time: they evolve in line with changing economic conditions, whether in the client's sector or in the broader economy. Consequently, risks must be managed dynamically, meaning that investors have to be able to sell their instruments prior to maturity so that, if need be, they can replace them with products matching the new situation.

One important aspect of investors' appetite to acquire such products (*including widely distributed products, see inset*) is the certainty that they can be sold before maturity. In practice, this assumes that the "issuing" financial institution undertakes to act as a market maker, ensuring secondary market liquidity for the issued products. For products issued in response to specific needs, a secondary market as such is impossible; in reality, therefore, the institution pledges to "redeem" the "issued" product from the client under certain conditions. In these cases, competition among market makers does not occur at this point, but rather at an earlier stage, when firms and investors issue requests for proposals to several financial institutions. At that point, the ability to unwind the position prior to the product's maturity is one of the key components of this proposal.

Market making and widely distributed derivatives

Among financial instruments, certain so-called structured products issued by financial institutions and designed to meet the needs of investors can be distributed widely, such as certificates, warrants and ETFs.

As with specific-purpose products, the certainty of being able to sell such instruments prior to maturity has a significant bearing on investor appetite. By undertaking to perform a market making function and ensure secondary market liquidity, the financial institution ensures that there is an active secondary market.

KEY CHARACTERISTICS OF MARKET MAKING

MARKETS ARE MADE ON TRADING PLATFORMS AS WELL AS OVER THE COUNTER

Through market making, the interaction between buyers and sellers can be synchronised, thereby increasing liquidity regardless of where the trade is executed. In practice, furthermore, market making is both on trading platforms and over the counter.

Historically, multilateral trading platforms (regulated markets and multilateral trading facilities) have existed principally on the equity segment, where they play an important role in providing market structure. In the derivatives segment, they cover standardised contracts and options, while on the bond segment, they have recently begun to develop for certain products.

Market making on platforms

While the quote-driven market model is intrinsically built around market makers competing with each other, it has long been acknowledged that the market making function is equally important in order-driven markets. The economic efficiency of a price given by an order-driven market model increases with the volume of purchases and sales that are matched, which assumes in particular that an attempt is made to reduce as far as possible any imbalance between buying and selling. Thus, to supply additional liquidity, and to reduce the situations in which buyers and sellers are not present at the same time for similar quantities, market participants using multilateral platforms have for quite some time now considered it useful to allow market makers to use their order book for orders that meet certain price and quantity conditions, giving them certain pricing advantages in exchange for the obligations they take on as a result. Following the same principle, these same platforms also offer mechanisms by which market makers respond to requests for quotes from investors.

On-exchange and over the counter: the balance is shifting

In the past, the market's price-setting function has taken place on "exchanges", which have long allowed investors* to trade equity and debt (shares and bond), as well as commodity derivatives and, for the last 30 years or so, financial derivatives.

However, the reality today is very different. Exchanges, which have become regulated markets, no longer have a predominant share, measured by either volumes** or products, of trading in financial instruments designed to meet financing needs or manage economic risks. The reasons for this development differ considerably from one market segment to the next.

- Derivatives

  While markets for commodity derivatives are among the oldest exchanges in the world, financial derivatives markets, which now account for a huge share of this segment, developed much later. In general, when it comes to risk management products, the challenge is to cover potentially diverse needs as precisely as possible. This is never entirely possible using products that are standardised, a requirement for exchange-based trading. As a result, a sizeable over-the-counter market has grown up to meet the firms' and investors' specific needs as closely as possible.

- Bonds

  Long exclusively dependent on exchange trading, the bond market has seen the bulk of trading shift off-exchange since the 1980s. This came about under pressure from governments, which substantially increased their debt issuance and wanted to reach out more to international investors, the only ones capable of matching sovereign needs, which meant breaking out of the national frameworks in which most exchanges of that era were ensconced. These days, while there are still bond markets that exist in the form of exchanges (notably in Italy), in reality they are mainly used to serve a particular clientele and their trading volumes are marginal.

- Equity

  Until very recently in many European countries the equity market was basically organised around exchanges that had a legal monopoly. And yet, the central trading system created by these exchanges mainly handled small orders, with large (or "block") trades taking place outside the central system between intermediaries under special pricing conditions set by the exchange. The challenge, both for the investor in question and for all investors and the issuer, is to make sure these trades do not unduly influence the price-formation process, as the absorption of a large trade within a central order book inevitably creates price movements called "market impact".

  Since 2007 and the entry into force of the Markets in Financial Instruments Directive (MiFID), one of the main goals of which was to foster competition among the three major forms of trading (regulated markets, multilateral trading facilities and over the counter), OTC volumes have risen gradually. The trades executed outside of the central order book now include not only large blocks, but also smaller orders. This development is the direct result of the development of internal order-matching systems created by financial intermediaries to fulfil the MiFID best execution obligation while also seeking the best economic equilibrium for their activity in accordance with the enhanced competition objective cited above.

Today, transactions in derivatives, bonds and equities are split between regulated markets, multilateral trading facilities and OTC systems. This balance is clearly shifting, with the share of on-exchange trading rising substantially***. Even so, there is no questioning the usefulness of OTC trading to meet the specific needs that gave rise to them in the first place.

** Commodity derivatives markets are among the oldest known markets in the world, dating back to Antiquity. "Exchanges" first appeared in the Middle Ages. However, the "modern" history of financial markets did not really begin until about two centuries ago.*

*** In 2012, Deustche Börse, the London Stock Exchange and NYSE-Euronext had less than 35% of the market in the stocks making up their primary indices.*

**** Clearing of derivatives trades under the European Market Infrastructure Regulation, review of MiFID, one of the goals of which is to mandate the use of trading platforms for bonds and certain liquid derivatives.*

Originally developed on derivatives platforms, the market making function subsequently spread to other cash platforms, meaning essentially equities.

For these platforms, market making has advantages both for illiquid and for liquid securities:

- For low-liquidity securities, a bid-ask spread is maintained in the order book, providing a reference price for investors who want to trade;
- For liquid securities, the existing spread narrows, thus lessening price distortion among trades in a single instrument at different locations, reducing temporary imbalances between buyers and sellers and ultimately avoiding unnecessary volatility.

Over-the-counter market making

Market making has also developed outside of multilateral trading facilities in a market context where OTC trades have been equally important, if not more so. Stemming directly from the MiFID goal of fostering competition among trading formats, OTC market making concerns instruments that are also traded on platforms (equities, standardised derivatives and some bonds). But it also concerns instruments that can only be traded over the counter (bonds, customised derivatives, etc.) because they have low liquidity and are ill-suited to trading on a multilateral platform.

Some recent regulations, such as MiFID 2 and the Short Selling Regulation, have tended to narrowly define market making activities, limiting them to platforms. This is not consistent with the real nature of these activities, which support trading in instruments both on- and off-platform.

COMPONENTS OF THE MARKET MAKING BUSINESS MODEL

The market making business model has several characteristics unique to the institutions that practise it. These include a substantial clientele to ensure sufficient information, a balance sheet large enough to take positions, continuous access to several markets for the purposes of financing and hedging, among others, and the expertise needed to supply competitive price quotes, even in times of high volatility.

However, the typical market maker has two main sources of revenue:

- Facilitation revenues from the bid-ask spread, which the market maker uses to pay itself and from which execution costs are subtracted;

- In cases where a counterparty cannot immediately be found, inventory revenues, which stem from changes in the value of inventoried assets and any income they may generate (dividends and interest), minus financing costs, cost of capital and hedging costs.

Inventorying is indispensable

The services provided to investors imply that the market maker is not merely a passive agent, acting solely in response to client requests. It must also anticipate their future needs.

Just like a shopkeeper maintains an inventory in order to be ready when clients appear, market makers anticipate client demand and, based on the economic interest they see in price levels and their capacity for offering clients products at a price that will appeal to them, seize opportunities that come along. This inventory activity is an important component of the business of over-the-counter market making.

Furthermore, the European Central Bank recognised that inventorying is a part of market making in its opinion on the proposal of bank structural reform (« *Market making is sometimes also carried out in anticipation of client business* »).

This view is shared by the European Securities and Markets Authority (ESMA), for which inventorying falls squarely within the business of market making. The guidelines published 4 April 2013 (ESMA/2013/7) on the European Short Selling Regulation specify: "An entity dealing as principal in anticipation of client orders or requests expected to materialise in the near term can benefit from the market making exemption to the extent that the anticipated hedging is necessary for the performance of actual market making activities and is not carried out on other grounds, such as speculative."

The size of the bid-ask spread (and hence the cost to the investor) upon which the market maker takes a position depends on several factors.

- The first is the estimate of the various costs entailed. This estimate tends to be lower if the market maker thinks it can find a counterparty quickly, or if the inventory costs, which depend partly on regulatory constraints (cost of capital) and derivatives markets (hedging), are low.
- The bid-ask spread proposed also depends on how much risk the market maker is taking, measured in particular by calculating value at risk (VaR), which helps determine the optimal inventory and adjust the bid-ask spread to reach that optimal level.
- The spread depends on each market maker's risk appetite for a given financial instrument and is measured directly by the level of capital earmarked for the activity.

These factors are internal to each institution – for instance the willingness to dedicate capital to the activity and the risk calculation method used – but also have an external component (capital adequacy requirements, ability to hedge positions, etc.). Taken together, they determine not only the financial institution's willingness to perform market making activities, but also the price, i.e. the width of the spread, at which they are prepared to deal with investors.

Given that the market making business model has already been undermined by the sharp rise in the cost of capital of these activities, it is important to protect the current equilibrium. Otherwise, the number of market makers could decline still further. This would be detrimental to issuers and investors and would take the heaviest toll – as recently pointed out by the BIS – on the least liquid markets, where inventory risks are the highest owing to longer warehousing periods and fewer hedging options[6].

EUROPE MUST RECOGNISE THE VALUE OF MARKET MAKING

FRANCE HAS OPTED TO PROTECT THE ECONOMIC VIABILITY OF MARKET MAKING

That market makers' real contribution is often questioned is due to a misunderstanding of what they do. Admittedly, there is no commonly accepted definition of market making, which is bound up with intricacies of how markets operate. And in reality, the concept of market making increasingly covers a highly diverse range of activities[7] with characteristics that differ widely depending on the liquidity of the instrument in question and the conditions under which it is typically traded. Regardless of its goals, however, the end result of market making remains the same: it is a way of supplying liquidity to end users for the purposes of investment, financing or hedging.

The usefulness of market making was a key topic in the debates that in France led to the creation of a financial transaction tax and the separation of certain banking activities. One of the major themes running through both of these reforms was the need to distinguish activities considered "useful", in the sense that they serve the needs of client firms and investors, from those deemed "speculative", meaning those pursued primarily if not exclusively in the economic interest of the person performing them. Because market making involves using the institution's own account, it came to be seen by some as blurring the line between "useful" and "speculative".

However, considering the issues at stake, the decision was made to protect the economic viability of market making done for the benefit of clients. To this end, authorities deemed that certain transactions necessary to market making should be protected and benefit from the same treatment as the client transactions they make possible. This indispensable choice was applied equally to counter trades, hedging transactions (using derivatives or performing trades in the underlying instrument) and transactions made for inventory purposes.

---

[6] This was clearly spelled out by the CGFS of the BIS in its November 2014 report, *Market-making and proprietary trading: industry trends, drivers and policy implications*.

[7] The realisation that market making has been understood differently in different legal texts depending upon the needs that each seeks to cover, for example market considerations (Short Selling Regulation, MiFID, etc.) or tax considerations (financial transaction tax in France, SDTT in the UK, etc.), has certainly contributed to this state of affairs. In each instance, given the economic interest of ensuring liquidity to markets or to clients, the aim has been to exempt institutions that practice this activity from certain constraints, or even to grant them certain benefits to offset their risk taking.

EUROPE MUST FOLLOW SUIT

While wholly endorsing the view that the definition of market making ought not include unduly "speculative" activities, at the same time it is vital that the activity not be defined too narrowly. Overly limiting the scope of market making as a precaution (considering that only activities carried out on a multilateral platform are legitimate) would jeopardise this activity's business model. It is also vital to make sure that counter trades, hedging transactions[8] (using derivatives, notably) and transactions made for inventory purposes are treated the same as market making transactions (whether they are made with clients or on platforms). If these two conditions are not met, Europe will destroy the business model of an activity whose costs in terms of capital requirements have already been raised significantly by prudential reforms. The immediate consequence of such a decision would be to restrict the services that market participants can provide to their clients and, beyond that, the market, which would be detrimental to the interests of all involved, and particularly detrimental to the market's ability to play its role in financing firms and hedging their risks.

Considering that the current debate is based on an inadequate European definition of market making adopted in the highly specific – and highly sensitive at the time – context of enacting regulations governing short selling, it is of the utmost importance to ensure that:

- The structural reform of the European banking sector does not lead to the spinning off of market making activities that serve clients.

- These activities are exempt from the financial transactions tax, regardless of the scope or shape that the reform ultimately takes.

Furthermore, it is vital that the European version of the capital adequacy rules laid out by the Basel Committee does not lead to greater restrictions on market making activity. This point is particularly important with respect to the implementation in Europe of rules related to the Net Stable Funding Ratio.

[8] Hedging transactions depend upon the specifics of each institution's risk management policies, which are themselves adopted in response to the various risks the institution faces. As a result, to optimise coverage, hedging is not necessarily done for each individual transaction. More often, needs are assessed and managed in relation to the risks inherent in an activity or group of activities.

BIBLIOGRAPHY

Reports and opinions

- *Opinion of the European Central Bank on a proposal for a regulation of the European Parliament and of the Council on structural measures improving the resilience of EU credit institutions*, ECB, 19 November 2014

- Study Group chaired by Denis Beau, « *Market-making and proprietary trading: industry trends, drivers and policy implications* », Committee on the Global Financial System, CGFS Papers No 52, November 2014, Bank for International Settlements

- *Annual Report 2014*, Office of Financial Research, December 2014

- *Financial Stability Review*, European Central Bank, November 2014

- *Impact of Bank Structural Reforms in Europe*, report by PwC for AFME, November 2014

Articles

- Jean-Edouard Colliard and Peter Hoffmann, « *Sand in the Chips? Evidence on Taxing Transactions in Modern Markets* », July 2013

- D. Duffie: « *Market Making Under the Proposed Volcker Rule* », Report to the Securities Industry and Financial Markets Association, January 2012

- A.V. Thakor, A.V., « *The Economic Consequences of the Volcker Rule* », Center for Capital Markets Competitiveness, Summer 2012