

Non-Equity Market Transparency

ESME's Report to the European
Commission

June 2007

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ESME's mandate

1. The European Securities Markets Expert Group ("ESME") is a group comprising industry experts from across the market spectrum. It includes representatives from large investment banks ("sell-side" firms), major investment managers ("buy-side" firms) along with representatives from issuers and market infrastructure providers (exchanges and MTS). The European Commission (the "Commission") created the group to provide it with advice on major, potential issues that might impact adversely on the functioning of financial markets, and thus merit intervention of some form by the public authorities. Members of ESME are not there to represent their firms but to contribute their expertise and understanding of financial markets to help the Commission understand the potential impact of such issues and the options available to respond to them.
2. Membership of ESME is set out in Appendix III.
3. The Commission is required by the Markets in Financial Instruments Directive ("MiFID") (Article 65), on the basis of public consultation and in the light of discussions with competent authorities, to report to the European Parliament and to the Council of Ministers on the possible extension of the scope of the provisions of MiFID concerning pre- and post-trade transparency obligations to transactions in classes of financial instruments other than shares. Broadly speaking, the pre-trade transparency requirements in MiFID in respect of shares require regulated markets ("RMs") and Multilateral Trading Facilities ("MTFs") to publish current bid and offer prices for shares and the depth of trading interest at those prices. MiFID also requires investment firms who are "systematic internalisers"¹ to publish firm quotes in liquid shares which they systematically internalise. In terms of post-trade transparency, MiFID requires RMs and MTFs to make public the price, volume and time of the transactions executed under their systems in respect of shares which are admitted to trading on an RM. Investment firms that conclude transactions in shares outside of an RM or MTF must also make public information relating to those transactions.
4. In order to help it fulfil its Article 65 obligations, the Commission mandated ESME to report to it by end-June 2007 on several issues relating to transparency in non-equity markets, which it had identified following a public call for evidence on transparency in these markets. These are summarized in Box 1 below.
5. This report seeks to provide answers to the Commission's questions. The answers presented draw on ESME members' direct experience as market participants and their work in analysing the data relating to and structure of bond markets, as well as academic research (some of the key academic literature drawn upon in this report is listed Appendix II). Where relevant, additional material supplementing the answers presented in this report is set out in Appendix I.

¹ A "systematic internaliser" is an investment firm which, on an organised, frequent and systematic basis, deals on own account by executing client orders outside an RM or MTF.

Box 1: Commission's questions

1. Does ESME consider there to be convincing evidence of a market failure with respect to market transparency in any of the instrument markets under review?
2. What evidence is there that mandatory pre- or post-trade transparency would mitigate such a market failure?
3. To what extent can the implementation of MiFID be expected to change this picture?
4. Could it be feasible and/or desirable to consider extending mandatory transparency only to certain segments of the market or certain types of investors?
5. A number of suggestions have been put forward by respondents to improve transparency of the markets in a way that does not involve market transparency in the sense used by MiFID, such as:
 - a) transparency of aggregate net risk positions on the part of particular trading venues or market participants;
 - b) transparency of overall market activity; and
 - c) increased transparency of effective margins and increased periodic reporting obligations relating to securitised derivatives.Does ESME see merit in any of the suggestions put forward of this kind? More specifically, does it consider there to be a convincing case for the need to mitigate a market failure by adopting one or more of them in any of the non-equity markets under investigation?
6. Does ESME support moves towards establishing a self-regulatory solution to issues of:
 - a) retail access to information about bond market transparency?
 - b) the need for better information on overall market activity?

Explanatory note: “the instrument markets under review”:

The Commission's mandate to ESME focused on government, supranational and corporate bond markets. The Commission asked ESME to consider the impact of other, mainly derivative, markets on the cash markets, but did not ask ESME to consider the much wider range of non-equity markets. While ESME's mandate is strictly wider than bond markets, for convenience, the markets under review in this report are broadly referred to as “bond markets”.

In terms of geographic scope, this report focuses on the trading in European markets of government bonds and supranational and corporate bonds listed in Europe.

Answers to the Commission’s questions

Q1. Does ESME consider there to be convincing evidence of a market failure with respect to market transparency in any of the instrument markets under review?

6. Before considering whether there is convincing evidence of market failure with respect to bond market transparency, two preliminary questions must first be considered in bond market terms:
- What is meant by “market transparency”?
 - What is meant by “market failure”?

What is meant by market transparency?

7. It is first important to consider what is meant by “market transparency” and what type of transparency is being referred to. The term “market transparency” can refer to the availability of information about the prices at which trades can be executed – this is “pre-trade” transparency. Market transparency can also be used to refer to the availability of information about the prices and volumes at which trades have been executed – this is “post-trade” transparency. The degree of pre-trade and post-trade transparency can vary considerably both in terms of what information is available and the frequency it is made available. In some markets, such as equity markets, much more information is made available both pre- and post-trade. In others markets, such as most bond markets and over the counter (“OTC”) derivative markets, much less information is generally available.
8. Pre- and post-trade transparency can be broken down at a high level in the ways set out in Table 1 below.

Table 1: high level view of pre- and post-trade transparency

PRE-TRADE TRANSPARENCY

| Indicative or tradable prices | Indicative or tradable quantity | Real time or delayed publication |
|--|---|---|
| Prices can either be indicative or firm, tradeable prices. If they are indicative then you could usually contact a dealer to obtain a firm, tradable quote. Prices on exchange-traded markets, such as an exchange’s order-book, are usually firm prices but prices in OTC markets are usually indicative. | Can you see the depth of interest in trading? On exchange order-books you can usually see the volume of a security investors are willing to buy and sell at various prices. In OTC markets you may just see that prices are good for up to certain volumes but will then differ if an investor wants to trade in larger size. | Is the information made available on a real-time basis, i.e. it updates as dealing interest changes, or is it published some time after dealing interest has changed? The degree of delay may be determined by the price paid for the information. In some markets delayed information may be available for free but real-time information may be available at a cost and the amount of information that is available may differ by cost. |

POST-TRADE TRANSPARENCY

| Price | Quantity | Real time or delayed publication |
|--|--|--|
| The prices at which trades have been executed. | The size of executed trades. In some markets the size of trades may be subject to some disguising, such as indicating that the trade was in excess of a certain threshold. In others it may be the full amount of the trade. | Does the information update as trades are executed or is publication delayed? The degree of delay may depend on the size of the trade. |

9. It is also worth reviewing at this point the information currently available to bond market participants, since this should form the proper foundation for any debate as to whether levels of transparency should be increased. Table 2 below summarises the information currently available to the various types of participants in bond markets. The table does not generally attempt to differentiate levels of information by type of bond.² However, the amount of information that is available (either electronically or through direct communication with dealers) will generally be lower in less liquid markets. In addition, even in liquid markets the coverage is unlikely to be complete either by instrument or dealer and access to the information may not be free.

Table 2: Existing information by investor type

| Investor type | Pre-trade information | Post-trade information |
|---------------------|---|--|
| Large broker-dealer | <ul style="list-style-type: none"> • “B2B” <ul style="list-style-type: none"> ○ Exchanges/MTFs (Eurex Bonds, MTS, SWX, Luxembourg Stock Exchange, etc) ○ Dealer facing broker platforms (E-Speed, BrokerTec, etc) • “B2C” platforms <ul style="list-style-type: none"> ○ Multi-dealer to client platforms (TradeWeb, Bondvision, Market Access and others) ○ Proprietary dealer to client platforms • Data vendors (Bloomberg, Reuters, etc) • Voice-trading (“Request For Quote” or RFQ trading) | <ul style="list-style-type: none"> • Access to ICMA’s³ next day post-trade information on aggregate volumes and closing prices of transactions traded off-exchange • Access to exchange data on the limited number of bond trades executed over the exchange • Information available from providers such as the International Index Company • B2B and B2C platforms (see previous column) |
| Small broker-dealer | <ul style="list-style-type: none"> • As above, though access to MTFs may be limited if not | <ul style="list-style-type: none"> • As above |

² Paragraphs 1 - 2 and Box 1 in Appendix I discuss further the particular transparency, risk and liquidity features of the various different instrument types comprising the cash bond markets.

³ ICMA (International Capital Market Association) is a self regulatory organisation (SRO) for the bond market industry. Certain members of ICMA, mostly dealers and other UK institutions, are obliged to report bond trades to ICMA on a daily basis. ICMA use this data to provide some information about market activity – averages of closing quotes provided by reporting dealers and the high/low and weighted average prices - and according to ICMA’s own estimates their trading data covers approximately 70% of the overall bond market by value.

| | contributing prices | |
|---|--|--|
| Large institutional investor | <ul style="list-style-type: none"> • Multi-dealer to client platforms (TradeWeb, Bondvision, Market Access and others) • Exchanges/MTFs (Eurex Bonds, MTS, SWX, Luxembourg Stock Exchange, etc) • Proprietary dealer to client platforms • Voice-trading (RFQ) • Data vendors | <ul style="list-style-type: none"> • As above |
| Small institutional investor | <ul style="list-style-type: none"> • As above, though will need to pay for access to data vendors and multi-dealer platforms. • Access to single dealer platforms may also be limited if the firm does not trade in sufficient volume | <ul style="list-style-type: none"> • As above |
| Retail investor trading via an intermediary | <ul style="list-style-type: none"> • Intermediary is likely to be small broker-dealer with access to all the same information sources | <ul style="list-style-type: none"> • As above |
| Retail investor trading directly | <ul style="list-style-type: none"> • DMO direct access platforms for some government bond trading • Little information about the vast majority of corporate bond prices. Some exceptions such as Borsa Italia's MOT | <ul style="list-style-type: none"> • Newspaper/internet information on bond prices • Delayed web access to exchange data |

10. The summary in Table 2 shows that access to price information differs according to the investor-type. In wholesale markets, dealers and larger institutional investors have access to a range of information which is available from a number of sources in the form of the exchanges, platforms, and the other market participants with which they interact, as well as through data vendors. Such participants may also be able to gain additional price information on the underlying bond markets from their participation in related credit derivatives markets. At the smaller end of the institutional market, the lower volumes traded may mean that buy side participants have less or more costly access to price information than their large institutional counterparts, but there are still a range of information sources.

11. In terms of the retail market, where retail investors trade via an intermediary, the intermediary is likely to be a smaller broker-dealer with access to much of the same information as is available to other wholesale market participants. It is in the case of the retail investor trading directly where the price information available is likely to differ significantly from that available in the wholesale markets, although the level of information will differ depending on the type of bond in question. For government bonds, retail investors can obtain pre-trade information from direct access platforms and post-trade information from newspapers and the internet. However, there is little pre-trade information directly available to retail investors about the vast majority of corporate bond prices⁴ and they may only be able to gain post-trade information on a delayed basis via the internet (or through a broker).

⁴ Though even here there are some exceptions – see, for example, Borsa Italia's MOT system.

12. As compared to the equity markets, bond market pre-trade transparency is much more fragmented. A fuller discussion of the comparisons that can be drawn between bond and equity markets is contained in Appendix I. However, the fact that the manner in which pre-trade information is made available to investors is different to equities markets does not detract from the fact that considerable information is available. It also remains to be seen what effect the provisions in MiFID allowing the establishment of new trading venues and systematic internalisation in competition with incumbent exchanges, together with the provisions opening up the publication of post-trade data, will have on the fragmentation of market data relating to equities. The question of the appropriate level of transparency in non-equity markets has been the subject of much discussion and there are arguments both in favour of and against increasing the level of transparency in bond markets. ESME does not express a view on these arguments but a high level summary of the main points is set out in Appendix I, Annex A.

What is meant by market failure?

13. From the material surveyed to produce this report⁵ ESME identified only one substantive framework for analysing when a market failure has occurred that would justify regulatory intervention. This was the UK Financial Services Authority's *Guide to Market Failure Analysis and High Level and Cost Benefit Analysis*,⁶ which sets out a framework for analysing when a market failure has occurred that would justify regulatory intervention. The FSA's framework for analysing market failure also seems aligned with the recent CESR *Non-equity transparency Consultation Paper*⁷ discussion on defining market failure. In looking at the question of what is meant by market failure, this report draws heavily on the FSA's framework.
14. In economic terms, market failure is a substantial deviation from a perfectly efficient market. In a perfectly efficient market, consumers and producers have all relevant information with the result that prices match marginal benefits and marginal costs. Where this does not hold, too little or too much is produced and there is a welfare loss. Another way to consider the concept of market failure is in terms of market optimisation: many markets may be suboptimal, but intervention to correct one form of suboptimality could lead to unacceptable trade-offs and net economic costs. Market failure can be seen as a material or significant suboptimality justifying remedial intervention.
15. A perfectly efficient market exists only in economic theory. All markets have some element of failure. In financial markets not all information is available to all investors at the same time. For example, investors who pay for access to information services such as Bloomberg or Reuters will have more ready access to market information than those who wait for the morning paper.
16. Information asymmetry could, in principle, lead to bond market failure in a number of possible respects. For example:
- **Failure to achieve best execution:** from an investor protection perspective, asymmetric information may mean that intermediaries are unable to find the best trading opportunities for their clients (or verify that they have done so) and clients are unable to review whether they obtained best execution from their intermediaries. It could also hinder investors in revaluing portfolios on a realistic basis.
 - **Inefficiency in the price formation process:** some types of participant may not be in a position to judge at what price to place orders and whether it is appropriate to take given quotes. It may also be difficult or expensive for participants to gather the information needed to trade. As a result, the market price of a bond may fail adequately to reflect overall supply and demand, or be slow to incorporate new information. This in turn may widen spreads, discourage participation in the market and potentially affect new issuance.
17. However, information asymmetries can have positive as well as negative implications. For example, if all information was freely available to everyone, there would be little incentive for

⁵ Some of the key academic literature drawn upon in this report is listed in Appendix II.

⁶ November 2006. See further Appendix II.

⁷ May 2007.

firms to carry out research or assemble/produce other new information which stimulates the value chain.⁸

18. Transparency, or price information, is therefore a multi-dimensional concept that can have both positive and negative effects. This means that a linear relationship between transparency and liquidity, whereby increased transparency will automatically lead to increased liquidity, cannot be assumed.⁹

Evidence of market failure in relation to bond market transparency

19. The FSA *Guide to Market Failure Analysis* identified a number of factors that may indicate uncorrected market failures¹⁰, namely:

- wide dispersion of market prices
- concentrated market share or market power
- persistent excess profits
- investor (market user) complaints

Wide dispersion of market prices

20. The material reviewed in producing this report does not appear to show evidence of wide dispersion of bond prices across different dealers and trading platforms in Europe. From analysis of round-trip spreads (an analysis of pricing where a dealer buys and sells the same bond within a given time frame) in Europe, FSA concluded that “*prices for the same bonds bought and sold within a short space of time do not appear to be widely dispersed*”. They note that while retail trades face the widest round trip spreads, even retail trades do not show wide price dispersion.¹¹
21. Bond prices (and credit default swap (“CDS”) prices), like the prices of other financial assets such as shares, coalesce around a market price, reacting quickly to changing news. One structural reason underlying this lack of price dispersion may be the formulaic manner in which bonds are priced. A bond’s price will be determined by a number of underlying factors, such as its interest rate and its credit rating. Bonds with a similar credit rating, from similar issuers and denominated in the same currency will tend to have similar spreads to the same benchmark yield curve. This factor restricts the dispersion of bond market prices.
22. Price dispersion can also be considered from the perspective of the dispersion of prices between those available to professional investors and those offered to the (generally) small percentage of retail investors who participate (directly or indirectly) in bond markets. For example, if retail intermediaries offer retail investors a newly issued bond at par when the current market price for that bond is below par, this may provide some indication of suboptimality in the retail market.
23. Whilst there will almost certainly be instances where retail investors have overpaid for a particular security, from the material reviewed in producing this report ESME has not identified consistent evidence supporting an assumption of market failure in terms of a dispersion between

⁸ This was also noted in the Commission’s Feedback Statement on pre- and post-trade transparency provisions of the Markets in Financial Instruments Directive (MiFID) in relation to transactions in classes of financial instruments other than shares, November 2006, which noted that “A number of respondents pointed out that the existence of information asymmetries was not per se evidence of a market failure, as such asymmetries may be necessary in order to incentivise firms to collect or produce information about particular issuers or about market conditions.” (page 7).

⁹ This point is recognised in the study *Market Transparency, Liquidity Externalities, and Institutional Trading Costs in Corporate Bonds* by Henrik Bessembinder, University of Utah, William Maxwell, University of Arizona and Kumar Venkataraman, Southern Methodist University, October 2005, which notes that increased transparency could affect incentives to expend resources to become informed about non-public information affecting corporate bond values, which could in turn alter the informational efficiency of the market. Moreover, relations between market liquidity and transparency may not be linear. This means that any further increases in transparency may not necessarily be accompanied by further improvements in liquidity. The research advises additional investigation of relations between market transparency, liquidity, and informational efficiency.

¹⁰ Similarly, the CESR *Non-equities transparency* Consultation Paper, May 2007, set out externalities, information asymmetry, market power and sub-optimal supply of goods as ways in which market failures would typically be reflected in secondary markets for financial instruments.

¹¹ FSA Feedback Statement 06/4, which sets out FSA’s evaluation of the evidence and key conclusions following its survey on trading transparency in the UK secondary bond markets (page 17). The FSA cites round trip spreads in Europe as approximately 0.057% (drawn from FSA’s own sample data) which compares to 0.27% in the US (cited by Goldstein et al). They also estimate that round-trip spreads in retail-sized trades are approx 0.086% and for government bonds were even tighter at an average of 0.009%. The ECMI Policy Brief: *Bond market transparency: To regulate or not to regulate...* by Jean-Pierre Casey, December 2006 paper says there is no empirical evidence of bond yield dispersion (page 107).

the prices paid by retail investors and those paid by professional investors.¹² However, as discussed further below, there may be other reasons to look to increase the amount of information available to retail investors.

Concentrated market power

24. ESME members' experience is that it is true to say that trading in wholesale markets in any one security, in particular a newly issued corporate bond, may be dominated by a small number of dealers, most notably the lead managers for the issue. Most corporate bonds only have a few dealers because they are brought to market by a small group of banks. New issues are generally led by between one and three lead managers supported by a few other banks with more minor roles. The lead managers have no obligation to provide secondary market liquidity, but to support the clients they encouraged to invest, they will routinely make markets in the new issues they bring to market. This practice is not necessarily to the dealer's advantage because it allows other banks to guess which firm may be involved in particular transactions and try to take advantage of them. In government bonds, European government issuers often place secondary market obligations on the dealer(s), which can again lead to secondary trading in those securities being concentrated among a small number of dealers. However, from the evidence reviewed in producing this report, and in the experience of ESME members, generally speaking, Europe's wholesale capital markets are very competitive.¹³
25. In terms of retail markets, it should first be noted that direct retail participation in bond markets differs significantly between European countries.¹⁴ However, retail participants access the bond markets by a number of different means, with banks, brokers and financial advisers all being used.¹⁵ This would suggest that there is not a concentration of market power to suggest a market failure in this regard.

Persistent excess profits

26. ESME has not identified any academic or regulatory material evidencing the presence of persistent excess profits as an indicator of market failure in relation to bond market transparency. It is worth noting that although this criterion was established as an indicator of market failure in FSA's *Guide to Market Failure Analysis*, FSA's own survey of trading transparency in UK secondary bond markets which concluded four months earlier did not identify any evidence of persistent excess profits as an indicator of market failure in this regard.¹⁶ Further, since persistent excess profits could be considered a manifestation of concentrated market share or market power (discussed above), ESME has not considered this category further.

Investor complaints

27. Despite the recent focus on the issue of bond market transparency, from the material reviewed in producing this report there is little evidence of investor dissatisfaction with bond markets or of

¹² FSA Feedback Statement 06/4 also notes that the wider spreads faced by retail clients may to some extent reflect the fixed costs of dealing (page 21). CEPR *European Corporate Bond Markets: transparency, liquidity, efficiency* by Bruno Biais, Fany Declerck, James Dow, Richard Portes and Ernst-Ludwig von Thadden, May 2006 also comments that "...the [retail] bank charges a relatively large fee (e.g. 1%) to the retail investor" to compensate for the non-automated and labour intensive operational tasks (page 34).

¹³ *European High Yield Bonds* by Bruno Biais and Fany Declerck, March 2007 provides some evidence in this regard. They find that the number of dealers in high yield markets were lower than in the investment grade market. They comment that this could limit risk-bearing, competition and liquidity but then cite spread estimates as a counter to this. For liquid high yield bonds they found that there were 10-15 market-makers but this falls to 1-3 for the typical, moderately traded bonds. They add that the lack of dealers does hinder liquidity and that dealers are afraid they would be exploited by peers if they provide liquidity. In investment grade markets the authors have previously estimated there to be on average 25 dealers for Euro denominated bonds and 18 for sterling.

¹⁴ In only a few European countries (Italy, Germany and Belgium) is direct retail participation in bond markets significant. In other European countries (including the UK and France) retail holdings of bonds are notably lower than 5% of households' total financial holdings. CEPR: *European Corporate Bond Markets: transparency, liquidity, efficiency* by Bruno Biais, Fany Declerck, James Dow, Richard Portes and Ernst-Ludwig von Thadden, May 2006.

¹⁵ CEPR: *European Corporate Bond Markets: transparency, liquidity, efficiency* by Bruno Biais, Fany Declerck, James Dow, Richard Portes and Ernst-Ludwig von Thadden, May 2006.

¹⁶ FSA Feedback Statement 06/4.

harm that investors have suffered because of the way in which the bond market currently operates.¹⁷

28. Perhaps the most commonly cited examples of investor detriment in bond markets are the experiences of Italian retail investors in Parmalat and Government of Argentina bonds in the mid to late 1990's.¹⁸ Italy is one of the few jurisdictions in Europe where there is a high level of direct retail involvement in bond markets.¹⁹ The (unexpected) defaults of the Government of Argentina and the default and subsequently discovered fraud in Parmalat certainly caused losses amongst a large number of investors.
29. However, it is questionable whether a more transparent market could or would have wholly prevented these losses. It seems difficult to argue that simply knowing the price at which an investor could trade or at which transactions had taken place would have prevented investors from suffering these losses. Arguably, had retail investors been able to see declines in the market price of their investment they may have been encouraged to sell out earlier. In volatile markets, those investors with least access to price transparency are (arguably) more likely to suffer losses, though there is a limit to which transparency can prevent investor harm. There were a range of views within ESME members as to whether the sub-optimal price information available to retail investors in such circumstances constituted actual evidence of "market failure". Increased transparency may have allowed retail investors to mitigate their losses, at least to some marginal extent, or may possibly have led to a wider distribution of losses. However, in situations where an unforeseen, large scale default of this type occurs, transparency cannot wholly prevent investor loss. The views of ESME members here would appear to chime with those in CESR's recent Consultation Paper²⁰ on non-equity transparency, which states:

"The cases in recent years of losses sustained by investors when issuers such as Argentina and Parmalat defaulted on their outstanding debt cannot simply be traced back to a lack of transparency. There was a multitude of reasons for these defaults and, in retrospect, it cannot be claimed that these cases would have taken a different direction if mandatory transparency requirements had been in place."

30. More generally, complaints may arise because bond investments are not always a suitable investment for retail investors. The diversity of the bond market is an important consideration here. Whilst it is undoubtedly true that many bonds are effectively credit risk-free investments on the grounds that the borrowers, particularly European governments and supranational organisations, are extremely unlikely to default on their obligations, many other bonds bring significant credit risk and may not be suitable for all investors, who may not understand the level of risk they are exposed to nor have the financial standing appropriate to such investments. Similarly the interest rate risk associated with such bonds may mean that they are not suitable investments for retail investors. As discussed further in the response to Question 3, the new "suitability" regime MiFID introduces will impose obligations on investment firms to ensure that

¹⁷ For example, FSA Feedback Statement 06/4, which sets out FSA's evaluation of the evidence and key conclusions following its survey on trading transparency in the UK secondary bond markets, notes that only a minority of respondents argued for greater transparency, while the majority of respondents were broadly content with existing transparency arrangements (pages 12-13). Similarly, the EU Commission: *Feedback statement on pre- and post-trade transparency provisions of MiFID in relation to transactions in classes of financial instruments other than shares*, November 2006 states that most respondents opposed (in varying degrees) the introduction of mandatory transparency obligations because bond markets are functioning well and provide an adequate level of transparency for participants. CESR's Consultation Paper on *Non-equity transparency*, May 2007, states *"In the retail arena, it is difficult to identify a case or pattern of cases where investor protection has been compromised due to a lack of mandatory transparency"* (para 53). The only evidence of general investor dissatisfaction with bond market which ESME has found in the course of producing this report is the FIN-USE *Response to the Commission's Call For Evidence*, September 2006. This response refers to a growing appetite for retail investments in bond markets and is in favour of developing direct retail participation in bond markets. FIN-USE consider mandatory transparency, focusing on post-trade transparency in a form similar to the MiFID equity model, is necessary for direct retail participation to develop and distinguish between retail and wholesale markets in this regard. The response posits that market evolution and industry initiatives will not be sufficient to develop a transparent retail market with high standards of investor protection. However, it should be noted that there is no evidence cited in FIN-USE's response in support of their proposition of growing appetite for retail investment in bonds, and they call throughout their response for more research to have clear picture of retail participation in bond markets. The basis on which they state mandatory transparency is necessary to develop retail participation in bond markets is therefore somewhat unclear.

¹⁸ The list in Annex B of Appendix I illustrates further examples of bond defaults since 2001.

¹⁹ Bonds comprise 22.4% of total financial assets for Italian retail investors, compared with 1.5% in the UK (and 6.9% in the US) (ABI, *Bond markets in Italy: transparency and regulatory issues*, 19 March 2007).

²⁰ CESR Consultation Paper *Non-equity transparency*, May 2007 (para 53).

the investment advice they give to their investors is suitable for them, and firms will be obliged to take into account the financial position and the knowledge and experience of their retail investor and his investment objectives in making investment recommendations. These requirements will mean that investment firms must ensure the recommendations they make to investors are suitable in the light of those investors' needs and financial profile. As regards the risks associated with unsophisticated investors investing in the "riskier" end of the bond market, regulatory scrutiny and enforcement of MiFID's suitability regime would seem a more effective tool than any measures related to transparency.

Other arguments in favour of increased bond market transparency

31. The discussion in paragraphs 19 to 30 above focuses on whether there is convincing evidence of market failure with respect to market transparency in terms of material suboptimality. However, it is also worth considering whether, even in the absence of material suboptimality, there are any broader inefficiencies in the market where it could be argued that increased transparency might improve the functioning of the market.²¹ For example, might an increase in transparency in one or more sectors of the market increase market participation and thus deepen markets reducing the cost of capital to borrowers and benefiting savers. i.e. increase liquidity?
32. From this perspective, factors that would suggest the functioning of a "quality" market were considered, including:
 - **Issuance and traded volumes:** Other things being equal a large, active market where a large variety of investors could buy and sell what they wanted with (relative) ease, certainty and in confidence would tend to indicate a quality market.
 - **Bid-offer spreads:** Broadly speaking, markets with narrow bid-offer spreads would indicate a better quality market than markets where spreads were much wider.
 - The amount and type of **information** generally available to investors.
33. On many measures it seems hard to argue that the European bond markets are not a "quality market". Issuance²² volumes continue to increase, the CDS market continues to expand²³ and many commentators (including the CEPR and the FSA²⁴) have concluded that bid/offer spreads in Europe were tighter than equivalent spreads in the US. As regards traded volumes, a number of academic studies²⁵ conclude that the introduction of TRACE, the Trade Reporting and Compliance Engine introduced by the NASD to facilitate the mandatory reporting of OTC transactions in corporate bonds in the US, has had a positive effect in increasing market efficiency and reducing transaction costs. However, The Bond Market Association's ("TBMA") *Response to the Commission's call for Evidence* comments that the principal academic research on the effect of TRACE on the US corporate bond market does not analyse in any detail the effect of post-trade price dissemination on liquidity as defined by traded volumes and that most of the studies define and measure liquidity by bid-ask spreads, rather than trading volumes.²⁶
34. The information available to investors has been discussed in paragraphs 9 - 1112 above. In summary, a great deal of pre-trade information and significant post-trade information is available to professional investors, who undertake the vast majority of the transactions in European bond markets. The amount and type of this information has increased over the last few years driven by client (i.e. investor) demand, the growth in electronic trading and the increased competition

²¹ The discussion in paragraphs 15 - 22 of Appendix I surveys the arguments which have been drawn comparing transparency regimes in the equity markets and the US bond markets to those in European bond markets.

²² See further the data analysed in paragraph 16 of Appendix I.

²³ According to the British Bankers' Association Credit Derivatives Report 2006, September 2006 the size of the CDS market in 2006 is estimated at €20 trillion, up from \$5 trillion in 2004.

²⁴ CEPR: *European Government Bond Markets: transparency, liquidity, efficiency* by Peter Dunne, Michael Moore and Richard Portes, May 2006. FSA Feedback Statement FS 06/4. See also *European High Yield Bonds* by Bruno Biais and Fany Declerk, March 2007.

²⁵ Bessembinder, Maxwell and Venkataraman (2005); Edwards, Harris and Piwowar (2005); and Goldstein, Hotchkiss and Sirri (2006). Note that other academic studies, notably, *European High Yield Bonds* by Bruno Biais and Fany Declerk, March 2007, conclude that spreads in European high yield markets compare favourably with those in the US even after the introduction of TRACE and that the difference between investment grade spreads and high yield spreads in Europe is lower than in the US

²⁶ The Bond Market Association (now SIFMA): *Response to European Commission's Call for Evidence on price transparency in non-equity markets*, 2006.

associated with the reduction in spreads that has been seen. There would appear to be no reason to believe that this process will not continue and incorporate an increasing number of bonds.

35. However, there is less price information available to retail investors, particularly post-trade information, relating to corporate bonds. In the absence of overt retail demand in most European countries there is little hard evidence of market failure. However, the very lack of such demand and the absence of significant retail participation may itself reflect market failure. This may suggest that the overall quality of the bond market could be improved with some increase in the amount of post-trade information available to retail investors, although this is anecdotal comment and ESME has been unable to find any academic material to support this. Specifically from an issuance perspective, one ESME member commented that it is helpful to have as wide a market participation as possible including retail demand (which may lead to cheaper, if slower, execution of a primary dealing). Separate to the question of market failure, paragraph 52 below discusses how the provision of close of day information on bond prices in which retail investors are most active may enable retail investors better to police the best execution obligations which MiFID introduces.
36. As regards smaller fund managers, one of the conclusions in FSA's feedback statement²⁷ evaluating the evidence following FSA's survey on trading transparency in the UK secondary bond markets was that some smaller fund managers may benefit from increased transparency when it comes to valuing the positions they hold. While they would have access to pre-trade transparency they may not turn their positions over very quickly and it may not be practical constantly to seek pre-trade quotes for the purpose of valuing positions. Many investment banks will provide valuations to clients on positions but they generally have no obligation to do this and may only be willing to do so for positions they themselves hold in inventory. While other companies do provide price testing/verification services, these tend only to be available to firms which contribute prices. Were smaller managers able to see information about prices and/or traded volumes then this would aid their ability to value their positions reliably and take away some of the inherent subjectivity of valuations supplied by individual dealers (though it is likely that many investors will continue to seek valuations from their dealers).
37. In the experience of one ESME member, the lack of real time post-trade pricing in European bond markets may limit the investment strategies available to collective investment schemes (and thus the investments ultimately available to participants). This member also added that this limitation adversely affects the ability of EU based investment funds to offer real time Net Asset Value calculations of their units and thus to attract new US participants. It may also potentially reduce the demand for European bonds and their derivatives from real time priced US investment funds. However, this member cautioned that a more thorough, quantitative analysis was needed to assess the potential detriment of this possible effect.
38. In a similar vein, suboptimality can be considered from the perspective of financial innovation and the development of new financial products. Increased transparency may lead to the development of new indices and other new forms of financial instrument. However, from the material reviewed to produce this report, there was no evidence to support significant suboptimality in this respect and, as discussed further in the response to Question 2, the trade-offs which may follow from intervention to correct perceived suboptimalities would also need to be borne in mind.

²⁷ FS O6/4, para 4.11. However, note that FSA concluded: "*We are not clear that existing differences in the availability of trading information to different types of institutional participant reflects a market failure per se, as in any market there will be those participants with better access to information than others. This is a consequence of how markets function, and the nature of the role that particular participants play. Furthermore, best execution provisions are designed to protect participants (including buy-side firms) who are less well positioned to find the best prices. To the extent that there is a deficiency for certain fund managers, we consider that the issue is largely one of access to information that is already provided to others, rather than of a need to generate additional information. In other words, the markets as a whole already generate the information these players say they need to have confidence in the price formation process, and to mark portfolios to market.*" (para 4.13)

Conclusion

39. In light of the matters considered above and the papers reviewed in the process of producing this report, there does not appear to be convincing evidence of market failure with respect to market transparency in wholesale bond markets by reference to any of the criteria identified, namely wide dispersion of market prices, concentrated market share, persistent excess profits, or investor complaints. As regards retail bond markets, all ESME members were agreed that there appears to be some evidence of sub-optimality with respect to market transparency in retail bond markets, particularly in the case of post-trade information relating to corporate bonds. Some ESME members felt that there could even be possible signs of market failure with respect to market transparency in retail bond markets. For the reasons discussed further in the responses to Questions 2, 4 and 6, in the view of ESME members, the most appropriate way to address these retail issues would be through a market-led solution to provide end of day prices in retail sizes in the most liquid bonds.

Q2. What evidence is there that mandatory pre- or post-trade transparency would mitigate such a market failure?

40. Key public authorities appear to be increasingly cognisant of the fact that regulatory intervention is only justified where there is evidence to suggest both that the market is failing in some way and that regulatory intervention is the appropriate means to address this failure. For example, Charlie McCreevy, European Commissioner for Internal Market and Services, recently noted that:

“Regulators should only step in when needed. Only when absolutely necessary. Only when there is market failure. Only when the benefits of action unambiguously outweigh the costs. We call this better regulation. This is a misnomer. It is smart regulation.” (Source: Charles McCreevy speech at Finance Dublin 8th Annual Conference, 26 March 2007)

41. The FSA expressed similar views in the conclusion to its Feedback Statement 06/4 setting out FSA’s evaluation of the evidence and key conclusions following its survey on trading transparency in the UK secondary bond markets:

“We think great care should be taken where regulation impacts, or might impact, on the structures that a market has developed. While mandatory post-trade transparency might raise fewer concerns than pre-trade transparency about the affect on market structure, we are not convinced that regulation in this area would necessarily deliver net benefits, given the possible trade-off in many bond markets between transparency and liquidity provision.” (page 26)

42. This is an approach that ESME strongly supports. The full consequences of regulatory intervention cannot be known in advance and may have unintended, detrimental effects on their liquidity or efficient functioning. This is particularly the case in complex, heterogeneous markets, such as the cash bond market in a multi-jurisdictional region such as Europe (see further paragraphs 1 - 2 of Appendix I for a description of the heterogeneous nature of the cash bond market). The concept of ‘net’ benefit is key in this regard. Mandatory requirements forcing markets in a particular direction are not merited without substantial evidence of two key elements: (1) market failure, and (2) that regulatory prescription is the correct means to remedy the deficiency, such that the cost of the intervention will result in an overall gain to the market. (As has been noted, a high level summary of the main points in favour of and against increasing the level of transparency in bond markets is set out in Appendix I, Annex A.)

43. Even if some form of market failure does exist, public authorities should consider the costs of substantial changes to a market’s infrastructure and operation before proposing intervention. These costs are not simply the direct financial costs of implementation but also the impact that change may have on the market and consequently on investors. It is extremely difficult to estimate with any accuracy or confidence either the indirect cost of the change or the value of

the benefit that may follow. One of the key arguments frequently posed against the imposition of transparency obligations is that it would deter dealers from providing liquidity. As is explained further in paragraphs 4 - 5 of Appendix I, bond markets are essentially dealer markets with investment banks committing their own capital and providing liquidity to facilitate trading. If dealers feel that their ability to trade out of the large positions they have taken on will be compromised because of increased transparency requirements, they may be unwilling to provide this liquidity and withdraw from the market. A number of the reports reviewed in preparing this response have cited this as a concern in the evidence they evaluate.²⁸

44. To address the concern that liquidity may be withdrawn due to increased transparency,²⁹ before mandating increased transparency it should first be considered how reduced liquidity would impact the ability of investors to trade in the size they want at the speed they require. Would the net effect of such measures actually have a negative impact on the quality of the market? Moreover, what is the gain that may follow from mandating transparency? US academic research on TRACE³⁰ suggests that spreads would tighten, though the question remains how such effects can be known or quantified in advance.
45. It should also be considered whether the case for intervention in terms of evidence of market failure has actually been made. Many of the authors of the reports reviewed in preparing this report explicitly commented that they did not see convincing evidence of market failure in European markets.³¹ Others set out arguments in favour of increased transparency but fell short of attempting to consider the costs and benefits of mandating transparency.³² ESME agrees that many of the arguments in support of increased transparency have merit and we do not disagree that investors would probably benefit from having more information available to them, particularly with regard to post-trade transparency. However, we do not consider that the fact that benefits could follow from increased transparency is sufficient to conclude that there is convincing evidence of market failure warranting mandatory transparency. This is particularly the case when

²⁸ See for example: (1) CEPR *European Government Bond Markets: transparency, liquidity, efficiency* by Peter Dunne, Michael Moore and Richard Portes, May 2006, which concluded that increasing pre-trade transparency may reduce the number of quotes requested by investors from dealers. The resulting reduction in information gained by dealers may increase their risk exposure, potentially resulting in bigger spreads and lower liquidity, which would have a detrimental impact on the ability of investors to trade in the size and at the time they would like. "We conclude that the microstructure matters greatly...some degree of opacity seems necessary to induce dealers to supply both liquidity and pre-trade information." (2) FSA Feedback Statement 06/4 "We believe that concerns regarding the impact of greater transparency on less liquid bonds are probably well founded: most respondents suggest that a trade-off between transparency and liquidity exists here. We tend to agree, and think further research may be needed to identify the precise nature of this trade-off. The market has delivered greater transparency for liquid bonds of its own volition, but that provides little indication of the impact of mandating more transparency." (Annex 2, page 34). (3) CEPS, *Europe's Hidden Capital Markets* by Jean-Pierre Casey and Karel Lannoo, which concludes "price transparency is only one component of market transparency" and "[if the policy objective is retail investor protection] then it is misguided since the key to protection is the preservation of principal. If the objective of price transparency is to enhance market liquidity, the relationship is still too uncertain to decide anything concrete." (page 112) (4) *European High Yield Bonds* by Bruno Biais and Fany Declerk, March 2007 which in its concluding comments on transparency notes that smaller investors are critical of opacity and that the median buy-side participant is supportive of post-trade transparency but on two conditions: first, that drastic changes should be avoided and transparency should be limited (advocating delayed and anonymous prices and exempting large trades), and secondly that regulators should work with the industry. They also note that the majority of sell-side participants think that more transparency would reduce liquidity.

²⁹ It is notable that many dealers continue to argue that following the introduction of real-time publication of post-trade data with TRACE in the US, there was a withdrawal of liquidity on the part of dealers. There is academic literature both against and in support of such contention. Bessembinder, Maxwell and Venkataraman (2005); Edwards, Harris and Piwowar (2005); and Goldstein, Hotchkiss and Sirri (2006) all conclude that TRACE has had a positive effect in increasing market efficiency and reducing transaction costs, though differ in terms of the the *magnitude* of that impact. Conversely, see *European High Yield Bonds* by Bruno Biais and Fany Declerk, March 2007. The latter argues that spreads in European high yield markets compare favourably with those in the US even after the introduction of TRACE and that the difference between investment grade spreads and high yield spreads in Europe is lower than in the US.

³⁰ Bessembinder, Maxwell and Venkataraman (2005); Edwards, Harris and Piwowar (2005); and Goldstein, Hotchkiss and Sirri (2006). However, note that the TBMA *Response to the Commission Call for Evidence*, 2006 notes that the principal academic research studies on the effect of TRACE on the US corporate bond markets were generally conducted during a time (2003) of relatively benign and improving credit conditions, reduced volatility and credit spread tightening, or historically tight spreads from the higher credit risk conditions a few years earlier.

³¹ See, for example, FSA: *Feedback Statement 06/4 Trading Transparency in the UK Secondary Bond Markets – feedback on DP05/5*, July 2006, where FSA states that it does not believe there is any evidence of substantial market failures related to transparency in the UK wholesale bond markets; EU Commission: *Feedback statement on pre- and post-trade transparency provisions of MiFID in relation to transactions in classes of financial instruments other than shares*, November 2006, which concludes overall that any problems there may be do not amount to market failure and mandatory transparency obligations are unlikely to solve these.

³² See for example, ECMI Policy Brief, *Bond market transparency: To regulate or not to regulate...* by Jean-Pierre Casey, December 2006, which did not conclude on the market failure arguments and simply states that more transparency should be introduced with the key questions being how, by whom and under what conditions.

all the potential consequences of such intervention cannot be known, and when market-led solutions may be able to be developed to remedy any suboptimality, at least in part (see further below).

46. We also note similar feedback given to CESR in response to their call for evidence in March this year. The vast majority of respondents explicitly stated that they did not believe there was any evidence of market failure. Many from across both the dealers and investor communities also expressed the view that any measures to enforce transparency on the market may have unintended consequences of actually reducing liquidity in the market and damaging the efficiency of the market.³³ Similarly, most respondents to the Commission's call for evidence on bond markets opposed the introduction of mandatory transparency obligations because greater transparency would undermine liquidity in bond markets, which are largely OTC, and would threaten their continued development.³⁴
47. Finally, it should be considered that any benefits that may follow from mandatory enhanced transparency may be obtained at much lower cost and without mandatory intervention and its associated risk of unintended consequences. Matters have not stood still since the Commission was first tasked with reviewing the possible extension of MiFID's transparency provisions to other classes of instrument in 2004. Market-led initiatives have clearly emerged over the intervening period that have themselves led to developments in bond market transparency.³⁵ As discussed further in paragraphs 23 - 28 of Appendix I, the emergence of new electronic methods of trading bonds (both through both dealers' own systems and multilateral trading systems), the development of price testing services in relation to valuations, and the recent growth in the CDS market all indicate that market forces are driving increasing transparency in some sectors of the bond markets (though notably not in the more illiquid or higher risk products). The evidence of market led initiatives, such as iTraxx and Markit (discussed further in paragraph 67 below), in resolving bond market inefficiencies both effectively and efficiently should also be taken into account. Such trends militate against regulatory intervention in the form of mandatory transparency requirements.

Q3. To what extent can the implementation of MIFID be expected to change the picture?

48. A number of articles in MiFID are likely to have particular impact on the operation of bond markets and the behaviour of bond market participants — in particular, best execution and suitability.

Best execution

49. Best execution obligations have traditionally largely been the preserve of equity markets. However, MIFID clarifies that the scope of the best execution extends to "all financial instruments",³⁶ encompassing fixed income markets.
50. The likelihood is that, while most dealer-intermediary bond market activity will fall outside the scope of best execution,³⁷ the vast majority if not all trades with retail clients will attract best execution obligations. However, the obligation to the retail client rests with the intermediary that is providing the service to the investor. That intermediary will be required to take "all reasonable steps" to obtain the best possible result for his client when executing a client order relating to a bond. In bond markets, it is likely that those steps will necessitate the intermediary surveying a number of dealers before deciding where it is in the best interests of his client for him to trade.
51. As discussed in paragraphs 9 - 1112 above, there is a large volume of information available to intermediaries ahead of any decision to deal so as to facilitate their being able to comply with

³³ CESR: *CESR's Response to the Commission's Request for Initial Assistance on Non-Equities Markets Transparency*, November 2006

³⁴ EU Commission: *Feedback statement on pre- and post-trade transparency provisions of MiFID in relation to transactions in classes of financial instruments other than shares*, November 2006.

³⁵ See further paragraph 67 below.

³⁶ Directive 2006/73/EC, Recital 70.

³⁷ See Commission Working Document ESC-07_2007.

these best execution obligations. If there are concerns about the “best buy” lists in some intermediaries where the bonds are listed at par regardless of the market price, these are arguably concerns about whether the intermediary is meeting its own obligations to act in the best interests of its client. In such circumstances, the intermediary will know the prices at which it can buy (or has bought) those bonds and it should be obliged to ensure that the prices it sells them onto the retail investor are reasonably aligned to the market price taking into account its own costs.

52. The provision of more close-of-day trade information about prices in retail sizes in the most liquid bonds to retail investors may help them verify and/or challenge the prices at which they dealt (although this does not absolve the intermediary of its overriding responsibility to deal with the client fairly). Close of day information on bond prices in retail markets may enable retail investors to police this obligation effectively (to the extent they choose to do so), although this information is unlikely to be of much value in illiquid markets where a bond may go for weeks or months without being traded. Given the concerns which have been expressed regarding the potentially detrimental effects of increased transparency (see paragraph 43 above), there would not seem to be a case for an increase in other forms of price transparency on these grounds.

Suitability

53. As discussed in paragraph 30, MiFID introduces a new “suitability” regime which will impose obligations on investment firms to ensure that the investment advice they give to their investors is suitable for them. Firms will be obliged to take into account the financial position and the knowledge and experience of their retail investor and his investment objectives in making investment recommendations. These requirements will mean that investment firms must ensure the recommendations they make to investors are suitable in the light of those investors’ needs and financial profile. MiFID’s suitability regime should address some of the risks of investor harm associated with unsophisticated investors investing in the “riskier” end of the bond market. However, it should be noted that even the suitability regime has some limitations in this area, given that bonds are non-complex products under MiFID which can be sold execution-only. Further, the suitability regime would not prevent the type of harm in the event of unforeseen corporate defaults as described in paragraph 28 above, since such bonds would not have been ‘risky’ or unsuitable investments at the time of purchase.

Q4. Could it be feasible and/or desirable to consider extending mandatory transparency only to certain segments of the market or certain types of investors?

54. As noted in paragraph 39 above, while there does not appear to be evidence of market failure with respect to market transparency in wholesale bond markets, there appears to be some evidence of suboptimality with respect to market transparency in retail bond markets. (As noted above, some ESME members felt that there could even be possible signs of market failure with respect to market transparency in retail bond markets.) Some increase in post-trade transparency may lead to some overall benefit to the market in two main areas, namely:
- retail investor protection and evidencing best execution; and
 - improving portfolio valuations.

Retail investor protection and evidencing of best execution obligations

55. As has been noted above, European bond retail investors may benefit from the provision of more post-trade data to verify the execution quality they obtain. Since post-trade transparency can take various forms, the question then arises whether real-time information would be significantly more helpful to retail investors than close-of-day information about average prices, high-low trading ranges and, perhaps, aggregated information about traded volumes? In the view of ESME members, it does not appear that there would be significant additional benefit to retail investors from the provision of real-time information, but ESME considers that retail investors could benefit from some close-of-day information in retail sizes in the most liquid bonds for the

reasons discussed. In any event, even if it could be shown that real-time information was somehow more valuable to retail investors than close of day information, this raises the further question of whether this additional benefit would be worth the potential cost of providing that information. The concerns raised as to the potentially detrimental effects on liquidity arising from increased transparency have been noted above.³⁸

56. As regards professional investors, this report concludes above that there would not appear to be convincing evidence of market failure in relation to bond market transparency. There is considerable pre-trade information available to professional investors enabling them to satisfy themselves as regards the prices at which they execute and provision of real-time post-trade data would not in the view of ESME members provide any further support to professional investors. The arguments in favour of extending some form of additional transparency to retail investors would not therefore appear to extend to the professional segment of the market.

Portfolio valuation

57. The other main area where this report found arguments in favour of increased post-trade transparency was in relation to assisting the provision of reliable information for portfolio valuations,³⁹ although ESME does not conclude that there is convincing evidence of market failure in this regard. The question again arises as to what form such post-trade information should take to aid the ability of, in particular, smaller managers to value their positions reliably. ESME does not consider that real-time or near real-time information is necessary in this regard and it is likely that close-of-day information about prices and, potentially, delayed information about volumes would be sufficient, not least given the concerns raised as to the potentially detrimental effects of increased transparency noted above.

How should such increased transparency be effected?

58. In terms of the manner in which investors could be given more post-trade transparency there are three broad options:
- 58.1. **Do nothing and let the market develop.** Paragraphs 23 - 28 of Appendix I outline some of the material market developments in the major bond markets over the last few years. A key theme running through many of these changes is the increase in electronic trading and consequent increase in availability of pre-trade information to investors. All financial markets, bond markets included, continue to develop with new contracts and methods of trading all generally leading to more openness and availability of information. Much of this is driven by investor demand and also by dealer initiatives looking to capture increased trading flow. There are therefore sound arguments in favour of allowing market forces to dictate what information is made available.
- 58.2. **Regulatory action requiring more information to be published,** either in the form of MiFID equity-style transparency requirements or less intrusive but still mandated requirements. ESME does not consider that the introduction of MiFID equity-style transparency requirements is merited in the bond markets. For the reasons discussed in paragraphs 3 - 14 of Appendix I, there are fundamental differences in the structure of bond markets and equity markets - from the manner in which the securities are traded to the nature and investment objectives of the investors. These militate against simply applying a transparency regime which has in essence been designed for equities to the bond markets. This leaves the question of whether some other form of mandatory requirement should be explored. However, given the concerns highlighted above as to the unintended, potentially detrimental consequences of mandated transparency (see response to Question 2 above), ESME's clear preference is for the authorities to work with the market as discussed in option three, rather than prescribe mandatory requirements either on the market as a whole or in selective areas.

³⁸ See paragraph 43 above.

³⁹ See paragraphs 36 to 37 above.

58.3. **A market-led approach** to the provision of more information about bond market trading. There has been much debate in the industry in response to the Commission's call for evidence and there have been moves, led by the ICMA and the Securities Industry and Financial Markets Association (SIFMA), proposing that the industry take the initiative and consider ways in which more information could be provided to investors without risking the on-going participation of dealers in the market. ICMA have recently conducted a survey across their membership in the UK and the EU to gather their views on the current level of transparency in the European bond markets and whether the ICMA should propose an industry-led initiative to deliver more transparency to the market. (The results of the survey are available on ICMA's and CESR's websites.) ICMA have subsequently formed a Bond Market Transparency working group to assess the feedback from the questionnaires and consider proposals for future developments. ESME understands that ICMA will bring forward proposals in the autumn. SIFMA is also proposing to extend its current US retail focused website ('investinbonds.com') to adapt it to the European Market. The goal of the EU website will be to offer educational services and price information to investors. SIFMA members have approved the proposals and SIFMA is taking forward the development. In addition, ESME members are aware of other initiatives which may also lead to more information being made available to market participants. These are all approaches that ESME supports. As discussed further in the response to Question 6, ESME also believes there is firm evidence that market-led initiatives can respond to bond market inefficiencies both effectively and efficiently. As noted in paragraph 68, ESME recognises that regulators may wish to review the progress of such initiatives after an appropriate period.

Q5. A number of suggestions have been put forward by respondents to improve transparency of the markets in a way that does not involve market transparency in the sense used by MIFID, such as:

- a) transparency of aggregate net risk positions on the part of particular trading venues or market participants**
- b) transparency of overall market activity**
- c) increased transparency of effective margins and increased periodic reporting obligations relating to securitized derivatives**
- d) other suggestions**

59. In their feedback statement⁴⁰ the Commission noted that some respondents had suggested alternative approaches toward transparency that moved away from the usual concept of price and volume transparency. As an initial point, ESME would note that these measures do not appear to have been proposed in response to a market failure. For the reasons cited in the response to Question 2, ESME would caution against any mandatory measures to increase transparency in the absence of clear market failure. There would also seem to be some problematic aspects associated with each of the proposals below.

a) transparency of aggregate net risk positions on the part of particular trading venues or market participants

60. One suggestion was that market participants should be forced to disclose their aggregate positions in various fixed income securities in a similar way to which they are obliged to disclose large positions in individual equities. The disclosure thresholds for equities were harmonised in the Transparency Directive⁴¹ and, broadly speaking, investors holding more than a set percentage of a listed company's shares are obliged to notify the company via a disclosure to the market. The driving principle behind the disclosure obligations is one of control and ensuring

⁴⁰ EU Commission: *Feedback statement on pre- and post-trade transparency provisions of MiFID in relation to transactions in classes of financial instruments other than shares*, November 2006.

⁴¹ Directive 2007/109/EC.

that a company knows who its major shareholders are, though it has the added benefit of providing transparency to the market about who owns those positions.

61. ESME considers that it would be difficult to impose similar obligations on bond market investors. Bond holdings rarely convey any right of control over the issuer (ignoring any rights they have should a company want to change the terms of the issue or seek a waiver of any covenants). Such proposal would introduce a significant amount of complexity over what thresholds were applied and the benefits that would flow to investors are unclear. Further, the concerns expressed⁴² by dealers that increased transparency will impact liquidity negatively would be magnified if there was no anonymity about who held the position (since the relatively limited liquidity in most corporate bond investments would mean it would be possible for other firms to guess with some accuracy what trades they had executed, even if the trades were disclosed anonymously).

b) transparency of overall market activity

62. The ability to determine the overall level of market activity in equity markets arises because of the detailed, trade-by-trade transparency obligations on market users. There are no additional relevant disclosure obligations. The concerns regarding the imposition of real-time or close to real-time post-trade transparency obligations and their impact on liquidity have been noted elsewhere in this report. However, even if the only obligations were to give periodic, anonymised disclosure of overall volumes, the benefit of any periodic disclosure of overall market to investors remains unclear. This is hard to quantify because the benefits that would potentially flow from increased investors and liquidity need to be balanced against the potential loss of liquidity from market providers.

c) increased transparency of effective margins and increased periodic reporting obligations relating to securitized derivatives

63. We understand that this question arose out of a response to the Commission's Call for Evidence from Bundesverband Investment und Asset Management. Margins can refer to a number of concepts, such as a profit margin or the variation and initial margin paid on in respect of derivative contracts, and it was unclear from the response what the BVI were referring to. If the latter then, in the view of ESME, it is difficult to see how the disclosure of such information would benefit investors in the bond markets under review. If the BVI was referring to profit margins and the spread built into structured notes developed by investment firms, ESME considers that the discussion of whether profitability in individual contracts should be disclosed is much broader than the pre- and post-trade transparency discussions. In general, firms are under no obligation to disclose the profit and loss they may make on individual transactions and it is hard to see how they could be forced to do so in certain contracts. The BVI also commented on disclosure obligations with respect to structured bonds and it is worth noting that the Commercial Mortgage Securities Association (Europe) have recently issued guidance on how the disclosure obligations in the Market Abuse Directive should be applied in such markets.

d) other suggestions

64. This report and Appendix I allude to the diversity of characteristics within bond markets which makes it debatable how to apply transparency to these products. To address this issue, one ESME member has suggested a framework for establishing an industry-wide transparency rating for non-equities issues. The suggested framework would involve applying certain levels of pre- and post-trade transparency, ranging from full transparency to no transparency, upon issue and to existing issues based on certain variables (namely the size of the market, frequency of trading, participant types in the market, credit ratings of the issues, trading methodology, potential effects of disclosure on the liquidity to the marketplace and whether the product is listed or OTC). This is another industry or market-led solution which could be explored through trade associations.

⁴² See paragraph 43 above.

Q6. Does ESME support moves toward establishing a self-regulatory solution to issues of:

a) retail access to information about bond market transparency; and

b) the need for better information about overall market activity?

a) retail access to information about bond market transparency

65. ESME would support moves towards establishing a self-regulatory solution in the form of an industry or market-led solution to issues of retail access to information about bond market transparency. ESME supports the approach taken in the initiatives from SIFMA and ICMA discussed in paragraph 58.3.
66. A further important consideration is that a solution which the market is allowed to develop should avoid the unintended and unforeseeable detrimental effects on bond market transparency which may follow from regulators prescribing mandatory requirements. (See response to Question 2 above.)
67. There is also strong evidence that market led initiatives can respond to bond market inefficiencies both effectively and efficiently. The development of CDS indices and, in particular, the various iTraxx indices is one example. As the use of CDS contracts increased it became clear that the market as a whole would benefit from standardised reference data. The market was able to work together to establish the rules for the indices that now form the accepted reference data for many that facilitated certainty about pricing. Similarly, Markit, iBoxx and RED database cash-settlement auctions for CDS after credit events are all examples of market-led solutions successfully resolving market inefficiencies in terms of transparency or otherwise.⁴³ The STEP (short term European paper) market is another example of an increasingly successful and integrated market where a co-ordination failure was resolved by market participants (with Euribor EBF and the Euribor market with the ECB/Eurosystem acting as the catalyst). Similarly, Indexco, International Index Company, a retail-focused website publishing data on indices and underlying bonds that are part of FX, credit derivatives and bond indices is another example of an industry-led initiative.
68. These initiatives demonstrate that co-ordination among market players can effectively resolve inefficiencies in bond markets. The fact that the market can both recognise and respond to such suboptimalities also weighs against the imposition of mandatory provisions in relation to transparency which may have unforeseen and unintended detrimental effects on bond market structures. However, in recognising the value of such market-led solutions, regulators may feel the need to make clear to the market that they will monitor the development and effects of such initiatives as a means of fostering industry collaboration and solutions.

b) the need for better information about overall market activity?

69. As regards an industry or market-led solution to ensure better information about overall market activity, there is no convincing evidence of market failure in this regard and, as discussed in the response to Question 5(c), in the view of ESME's members there do not appear to be convincing arguments in favour of increased information about overall market activity in terms of investor benefit or otherwise.
70. As has been noted, ESME would however see merits in market-led initiatives aimed at providing empirical evidence on the positive and negative impacts on the European bond markets of enhanced trading transparency. A possible way to address this task would be through a market-led pilot project or a controlled experiment, where enhanced trading transparency is pursued, checked and reviewed in a flexible and controlled manner. In this regard, the purpose of

⁴³ See also European Central Bank Occasional Paper No. 50, *Implications for liquidity from innovation and transparency in the European corporate bond market*, August 2006, Box 1 page 15, for further examples of market-driven innovations that have had an impact on the liquidity of credit risk markets. The paper notes that these innovations "have enhanced the trading of corporate bonds and in particular credit derivatives, whose markets are nowadays more innovative, diversified and often more liquid than the underlying cash markets. Also in terms of price efficiency, prices available in the CDS market are increasingly accepted as a reference price source for pricing corporate bonds."

flexibility is better served by a market-led initiative. This exercise could be performed for a limited set of financial instruments and under conservative parameters (e.g. proper choice of liquid instruments and publication delays).