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## **Call for Evidence**

**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**

## Call for Evidence

### **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**

#### **1. INTRODUCTION**

The European Parliament and the Council have asked the Commission to report on the adequacy of the level of pre- and post-trade transparency in classes of financial instrument other than shares. The Report, required by Article 65(1) of the Markets in Financial Instruments Directive (MiFID)<sup>1</sup>, is due by 31 October 2007. The present document constitutes a call for evidence to be submitted to the European Commission services in relation to this report (the Report).

The purpose of this call for evidence is to present, and seek feedback on, the Commission's preliminary orientation towards the Report in terms of the methodology and scope, the sources of data, and the other modalities of the Report. A list of questions is annexed to this call for evidence (**Annex I**).

Evidence, preferably in the form of general remarks followed by answers to the questions listed in Annex 1, can be submitted by email to the following email address: [markt-g3@ec.europa.eu](mailto:markt-g3@ec.europa.eu). The Commission will publish all responses received on its website unless confidentiality is specifically requested.

The call for evidence will be open for comment until **15 September 2006**.

#### **2. BACKGROUND**

##### **2.1. Legal framework**

The report the subject of the present call for evidence is provided for under Article 65(1) of the MiFID Level 1. Article 65(1) provides:

1. By 31 October 2007, the Commission shall, on the basis of public consultation and in the light of discussions with competent authorities, report to the European Parliament and to the Council on the possible extension of the scope of the provisions of the Directive concerning pre and post-trade transparency obligations to transactions in classes of financial instrument other than shares.

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<sup>1</sup> Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, OJ L 145, 30.4.2004, p. 1 (as amended by Directive 2006/31/EC of the European Parliament and of the Council of 5 April 2006, amending Directive 2004/39/EC on markets in financial instruments, as regards certain deadlines, OJ L 114, 27.4.06, p. 60).

## **2.2. Consultation and sources of advice**

Article 65(1) quoted above mentions the Commission acting ‘on the basis of public consultation and in the light of discussions with competent authorities’.

The Commission’s White Paper on Financial Services Policy 2005-2010<sup>2</sup> set out our commitment to open and transparent consultation:<sup>3</sup>

Open consultations (including with stakeholder groups) will continue to play a central role and will be required before any legislation is deemed necessary. The Commission will continue to publish responses received to its consultations, practical summaries and feedback statements.

We will consult publicly twice during the preparation of the Report: firstly, by way of this call for evidence; and secondly, by way of a public consultation on a draft of the Report. We will seek, wherever possible, to include consumer and investor input in this public consultation.

We will also ask the Committee of European Securities Regulators (CESR) to provide expert and focused advice on factual and regulatory questions. The involvement of CESR is intended to fulfil our obligation to hold discussions with competent authorities.

We will also use our recently-formed European Securities Markets Expert Group (ESME)<sup>4</sup> to provide input into the report at an appropriate stage.

Further, we might consider engaging specialist consultants if there is significant quantitative or qualitative work to be done requiring specialist expertise.

## **2.3. Methodology**

The Report will be prepared in accordance with Commission’s initiative on better regulation<sup>5</sup> and its guidelines on impact assessment.<sup>6</sup>

# **3. PROPOSED PROJECT DESIGN**

## **3.1. Scope of the Report**

The Report extends to transactions in all classes of financial instruments other than shares.

As the Report does not cover transactions in shares, there is no mandate to consider extension of transparency obligations to shares to which the MiFID transparency provisions do not apply, i.e. shares that are not admitted to trading on a regulated market.

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<sup>2</sup> Available at [http://ec.europa.eu/internal\\_market/finances/docs/white\\_paper/white\\_paper\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/white_paper/white_paper_en.pdf)  
<sup>3</sup> at paragraph 2.1

<sup>4</sup> See Decision 2006/288/EC, OJ L 106, 19.4.2006, p. 14.

<sup>5</sup> See Press Release number MEMO/05/340, Brussels, 27 September 2005 for a succinct summary.

<sup>6</sup> Impact Assessment Guidelines (SEC(2005) 791. See [http://europa.eu.int/comm/secretariat\\_general/impact/docs/SEC2005\\_791\\_IA%20guidelines\\_annexes.pdf](http://europa.eu.int/comm/secretariat_general/impact/docs/SEC2005_791_IA%20guidelines_annexes.pdf).

In referring to ‘the provisions of the Directive concerning pre and post-trade transparency obligations’, the provision should be read as including the provisions of the Directive and its proposed implementing measures relating to pre- and post-trade transparency.<sup>7</sup>

The options the Report is required to consider are not limited to a choice between applying the MiFID transparency provisions to transactions in all classes of non-equities or to none. It would be legitimate, therefore, for the Report to recommend those provisions be applied to a class or specific classes of non-equities.

Similarly, the provision does not require consideration only of two options: full MiFID-style transparency for each instrument class or nothing. We believe the ‘extension’ referred to includes the possibility of adapting that regime to the characteristics of a particular instrument market, the nature of the instrument market concerned and the characteristics of the investors who typically use that market. Therefore, one possible outcome would be to have more than one transparency regime (for example, more than one set of post-trade publication deferrals for large transactions) for different instrument classes.

***Question 1.: Do you have any comment on the proposed scope of the Report?***

### **3.2. Classes of instruments**

In the absence of any particular guidance in the MiFID as to how broadly to draw the ‘classes’ referred to, we have a certain degree of freedom to adopt our own approach in terms of the level of granularity to be applied to the analysis. (We do not believe the classification scheme in Article 4(1)(18) and (19) of the Directive is detailed enough to be relevant to this review, as it was drafted for a different purpose and in the present context is not sensitive enough to the differences in participation, risk and substitutability between the various markets.)

In exercising that freedom, we seek to balance the need to respect the particularities of each financial instrument market with the limits of the Commission services’ resources to investigate each market in detail.

For discussion purposes, we propose to adopt the following classification scheme for the purposes of the review. We explain below how we intend to focus and prioritise our review.

- Cash bonds
  - supnationals
  - government
  - investment-grade corporate<sup>8</sup>
  - high-yield corporate<sup>9</sup>

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<sup>7</sup> Those provisions are: Articles 27–30 and 44–45 of MiFID and Chapter IV of the proposed implementing Regulation (see draft dated 6 February 2006 published on the Commission’s website at [http://europa.eu.int/comm/internal\\_market/securities/isd/index\\_en.htm](http://europa.eu.int/comm/internal_market/securities/isd/index_en.htm)).

<sup>8</sup> Normally, those corporate bonds rated in the top four categories by commercial credit rating companies.

- emerging market
- Credit derivatives
  - Bond options and futures
  - credit default swaps
  - interest rate swaps
  - other credit derivatives (total return swaps, credit-linked notes, forward rate agreements (FRAs))
- Asset-backed securities (ABS)
  - mortgage-backed securities (MBS)
  - collateralised debt obligations (CDOs)
  - other ABS (e.g. covered bonds)
- Other financial instruments
  - commodity derivatives
  - foreign exchange (FX) derivatives
  - money market instruments
  - units in UCITS and other collective investment schemes
  - other financial instruments

*Question 2.: Do you consider this classification scheme to be sufficient for the purposes of the review?*

### 3.3. Focus and prioritisation

We do not intend to examine every class of instruments with the same intensity. In deciding on our priorities, we will be guided by the possible policy rationales for mandatory transparency. We think those possible rationales are:

- investor protection:
  - mandatory transparency can alleviate information asymmetries, putting different types of investors on a level playing field in relation to access to relevant information as to the most recent and best-priced deals;
  - it can enable investors to verify that they have received best execution from their brokers or dealers, and brokers and dealers to verify that they have provided best execution, by enabling them to compare prices across a range of trading venues with the prices secured for clients;
  - it can assist investors, particularly fund managers or valuers, in revaluing portfolios on a realistic basis. Periodic revaluation is often required under the terms of offer documents;
- market efficiency:
  - mandatory transparency can lead to more efficient price formation and more realistic prices by ensuring that price signals are more rapidly dispersed and integrated by the market;

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<sup>9</sup> (ie, sub-investment grade). This category is also intended to include distressed debt securities.

- it can promote more liquid markets by ensuring that all players have comparable access to information about real market conditions as well as by lowering transaction costs (such as spreads);
- it can help to ‘reintegrate’ liquidity that would otherwise be fragmented by allowing free competition between trading venues;
- response to technological developments:
  - in many markets, technological developments have increased reliance on more centralised, multilateral electronic trading as opposed to bilateral negotiations, creating an environment where transparency may be introduced or extended at a low cost;
  - technological solutions developed as part of the MiFID implementation, such as quoting engines for systematic internalisers, may become easily available and adaptable to non-equity financial instruments.

***Question 3.: Do you consider there are possible policy rationales for mandatory transparency we have not listed?***

Taking all of these possible policy rationales into account, we believe that our effort should be focused more on those markets where potential investor protection concerns are more prominent.

This is particularly relevant to markets such as cash government and investment-grade and high-yield corporate bond markets as well as asset-backed securities markets. These are areas where retail participation is expected to rise significantly due to population ageing and the resulting greater appetite for assets with relatively more predictable streams of income.

We also appreciate that there are other markets that are intimately linked to the cash bond markets., These are those derivatives markets which act as pricing drivers for cash bonds. Credit derivatives markets generally are growing continuously in importance relative to cash markets, and some of them play an important role in the pricing of cash bonds. For these reasons, we propose to investigate the credit default swap, interest rate swap and bond futures markets, and in particular the role they play in bond pricing.

As for units in collective investment undertakings, including UCITS, we do not intend to focus on this instrument class in our review, for two reasons. Firstly, secondary trading of funds is very limited outside the field of exchange-traded funds (ETFs). ETFs are subject to high levels of pre- and post-trade transparency through the rules of the exchanges that facilitate trading. Secondly, the unique characteristics of fund valuation – the periodic Net Asset Valuation calculation that is performed – means that pricing of units is inherently less affected by traded prices than for other classes of financial instrument.

We propose to actively investigate other financial instrument markets only to the extent that respondents consider that there are or may be problems that need to be addressed.

We therefore intend to focus our efforts, in decreasing intensity, on:

- cash government bonds;
- cash investment-grade corporate bonds;
- cash high-yield corporate bonds;
- asset backed securities;
- credit default swaps, interest rate swaps and bond futures; and
- other financial instruments, to the extent that respondents consider there are or may be problems that need to be addressed.

***Question 4.: Do you agree with our proposals for prioritisation of the review?***

### **3.4. Timing**

We have worked back from the end-October 2007 deadline in light of the above remarks to set out a preliminary set of milestones. The key milestones and deadlines applicable are set out in **Annex II**.

## **4. DISCUSSION**

### **4.1. Problem identification**

The first step is to analyse whether there is a problem that could be remedied by public policy and if so, what causes it, who it affects, and whether the EU level is the appropriate level to deal with it in view of the principle of subsidiarity.

As well as seeking to collect anecdotal evidence of existing problems, we will also seek to establish whether there is research or data available tending to show, in a rigorous way, that present arrangements are suboptimal, in the sense that greater transparency would have significantly beneficial impacts in terms of any of the possible policy rationales identified above or in terms of wider policy goals such as those of the Community Lisbon programme.

In respect of those markets we have identified as priority areas, we will be proactive in seeking to assemble and analyse data and evidence of potential problems. In respect of those markets we have said we will not investigate in detail, we will be less pro-active and will only act if evidence is provided to us of a problem with regards to transparency levels.

*Question 5.: To what extent do you consider there to be:*

*a. observable or demonstrable problems with respect to the possible policy rationales for transparency identified above in relation to one or more of the instrument markets under review?*

*b. evidence that mandatory pre- or post-trade transparency would solve any of those problems?*

*Question 6: To what extent could recent and upcoming technological and market developments in relation to the instrument markets under review:*

*a. contribute to a relatively inexpensive extension of mandatory transparency?*

*b. render mandatory transparency unnecessary?*

*Question 7.: To what extent are non-equity financial instruments different from equities so that lower levels of mandatory transparency in those markets may be justified?*

*Question 8.: What data sources do you consider relevant to the issues you have raised (if appropriate, cross-refer to your answers below)? Would you or your organisation be prepared to produce any relevant data if necessary?*

#### **4.2. Relevant academic and institutional work**

We have conducted a preliminary exercise, short of a full literature review, to seek to identify relevant academic and institutional literature that could be brought to bear on an impact assessment.

We enclose a bibliography of the literature that we have collected (**Annex III**). Much of this literature concerns transparency in the cash equities market or the US cash bonds market.

We welcome all contributions to the debate and await the outcome of ongoing work with interest.

*Question 9.: Are there academic or institutional papers or ongoing work that should be considered in preparing the Report not included in our bibliography?*

*Question 10.: What conclusions do you draw from the existing academic debate and the ongoing work being conducted by interested parties?*

*Question 11.: In your view, how applicable is the academic or institutional literature concerning transparency in the cash equities markets to the present discussion?*

***Question 12.: What similarities, and what differences, are there between US and EU markets that should be borne in mind when seeking to draw inferences from the TRACE<sup>10</sup> experience in the US?***

#### **4.3. Additional filters in problem identification**

If indeed we were to find that there were problems relating to the policy rationales for transparency in any of the markets under discussion, we would then need to address the following questions:

- whether the Union has the right to act, having regard to the subsidiarity principle.

We consider that, given the very high degree of cross-border trading and the highly integrated nature of the market, only EU-level action would be appropriate to tackle transparency.

- how would the problem evolve if the current EU approach were to continue?

***Question 13.: To the extent that you have identified problems or believe that others might do so, do you agree that only EU-level action would be appropriate in the present case?***

***Question 14.: If you have identified problems or believe that others might do so, to what extent do you consider those problems would disappear as a natural product of market evolution in the short-to-medium term?***

## **5. OPTIONS FOR DISCUSSION**

Assuming that a problem is identified in any of the instrument markets under discussion, the next step would be to define options for intervention, including a ‘no-change’ option and non-legislative options such as self-regulation.

Consistent with our discussion above, if a problem were to be identified in a particular instrument market, the options for that instrument market would need to be considered separately in relation to pre- and post-trade transparency.

### **5.1. Pre-trade transparency**

Here four basic options for each relevant instrument market might be analysed:

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<sup>10</sup> Transaction Reporting and Compliance Engine (TRACE) operated by the National Association of Securities Dealers or NASD. See the information presented by NASD at following hyperlink: [http://www.nasd.com/web/idcplg?IdcService=SS\\_GET\\_PAGE&nodeId=373&ssSourceNodeId=5](http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&nodeId=373&ssSourceNodeId=5) .

- a ‘no-change’ option;
- an option relying on self-regulation to deliver the objectives determined as discussed above;
- a mandatory MiFID-like system of pre-trade transparency, but without an equivalent of Article 27;
- a full mandatory MiFID-like system.

## 5.2. Post-trade transparency

Here the four basic options which could be analysed for each relevant instrument market might be slightly different:

- a no-change option;
- an option relying on self-regulation to deliver the objectives determined as discussed above;
- a mandatory TRACE-like system where all transactions are reported with a minimal delay;
- a mandatory MiFID-like system where volume information about trades is reported, but with a flexible system of delays according to volume.

## 5.3. Question for consultation

*Question 15.: In respect of both pre- and post-trade transparency, are the four options the right ones to consider, and in particular should other options be considered?*

*Question 16.: Would you, in light of your answers to the other questions, favour any of the four options in relation to pre- and post-trade transparency (or another option you might propose for consideration) in respect of transactions in any of:*

- *cash government bonds;*
- *cash investment-grade corporate bonds;*
- *cash high-yield corporate bonds;*
- *asset-backed securities;*
- *credit default swaps, interest rate swaps and bond futures; or*
- *any other financial instrument you consider relevant?*

## Annex I

### List of questions

*Question 1: Do you have any comment on the proposed scope of the Report?*

*Question 2: Do you consider this classification scheme to be sufficient for the purposes of the review?*

*Question 3: Do you consider there are possible policy rationales for mandatory transparency we have not listed?*

*Question 4: Do you agree with our proposals for prioritisation of the review?*

*Question 5.: To what extent do you consider there to be:*

*a. observable or demonstrable problems with respect to the possible policy rationales for mandatory transparency identified above in relation to one or more of the instrument markets under review?*

*b. evidence that mandatory pre- or post-trade transparency would solve any of those problems?*

*Question 6: To what extent could recent and upcoming technological and market developments in relation to the instrument markets under review:*

*a. contribute to a relatively inexpensive extension of mandatory transparency?*

*b. render mandatory transparency unnecessary?*

*Question 7.: To what extent are non-equity financial instruments different from equities so that lower levels of mandatory transparency in those markets may be justified?*

*Question 8.: What data sources do you consider relevant to the issues you have raised (if appropriate, cross-refer to your answers below)? Would you or your organisation be prepared to provide any relevant data if necessary?*

*Question 9.: Are there academic or institutional papers or ongoing work that should be considered in preparing the Report not included in our bibliography?*

*Question 10.: What conclusions do you draw from the existing academic debate and the work being conducted by other interested parties?*

*Question 11.: In your view, how applicable is the academic or institutional literature concerning transparency in the cash equities markets to the present discussion?*

*Question 12.: What similarities, and what differences, are there between US and EU markets that should be borne in mind when seeking to draw inferences from the TRACE<sup>11</sup> experience in the US?*

*Question 13.: To the extent that you have identified problems or believe that others might do so, do you agree that only EU-level action would be appropriate in the present case?*

*Question 14.: If you have identified problems or believe that others might do so, to what extent do you consider those problems would disappear as a natural product of market evolution in the short-to-medium term?*

*Question 15.: In respect of both pre- and post-trade transparency, are the four options the right ones to consider, and in particular should other options be considered?*

*Question 16.: Would you, in light of your answers to the other questions, favour any of the four options in relation to pre- and post-trade transparency (or another option you might propose for consideration) in respect of transactions in any of:*

- *cash government bonds;*
- *cash investment-grade corporate bonds;*
- *cash high-yield corporate bonds;*
- *asset-backed securities;*
- *credit default swaps, interest rate swaps and bond futures; or*
- *any other financial instrument you consider relevant?*

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<sup>11</sup> Transaction Reporting and Compliance Engine (TRACE) operated by the National Association of Securities Dealers or NASD. See the information presented by NASD at following hyperlink: [http://www.nasd.com/web/idcplg?IdcService=SS\\_GET\\_PAGE&nodeId=373&ssSourceNodeId=5](http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&nodeId=373&ssSourceNodeId=5) .

## Annex II

### Key milestones

Key milestone	Due/ release date
1. Consultation period on call for evidence ends	15.09.06
2. Feedback statement and publication of responses on website	3.11.06
3. CESR advice	31.03.07
4. ESME response	31.03.07
5. Draft report	30.06.07
6. Public hearing	July 07
7. Consultation period on draft report ends	September 07
8. Final report	31.10.07

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Committee of European Securities Regulators, Committee of European Banking Supervisors, and Committee of European Insurance and Occupational Pensions

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