

ABI Comments on the
European Commission Call
for Evidence:

*“Pre and post-trade transparency
provisions of the MIFID in relation
to transactions in classes of
financial instruments other than
shares”*

September 2006

Introductory comments

The Italian Banking Association (ABI), which with over 800 member institutions represents the Italian banking industry, welcomes the Commission's initiative on the extension of information requirements under MIFID. This is of crucial importance to achieving a truly integrated and efficient financial market.

ABI has always called and worked for the greatest possible transparency and availability of pre- and post-trade information as a prerequisite for intermediaries and investors to operate in the Single European Financial Market as a common space of full competition in the provision of investment services. Only when such uniformity of information is instituted at European level can we truly speak of a "single European market."

MIFID fosters competition between trading venues (regulated exchanges, multilateral trading facilities and systematic internalizers), prohibiting Member States from requiring intermediaries to trade on regulated markets, in the belief that competition will help to lower transaction costs and spur financial innovation. However, as intermediaries are free to choose among a large number of trading venues, it is likely that liquidity will be fragmented and that quote and price information will be dispersed, undermining the quality of the price discovery process, which is essential to competition itself. To solve this problem the Directive calls for pre- and post-trade transparency designed to guarantee participants' access to the quotes posted on the various venues (pre-trade transparency) and the final transaction prices (post-trade transparency).

The broader and more efficient the process of consolidation and access for intermediaries and customers to consolidated information, the less the risk of trades being made at terms much worse than the best available, which will improve the quality of securities prices. It is no accident that recital 34 of the Directive calls on Member States to eliminate the barriers to European consolidation of information and their publication.

The role of pre- and post-trade transparency varies with typical market participants and with the type of instrument traded. A high degree of transparency is needed to protect retail investors and uninformed persons in general. In financial systems characterized by the substantial presence of retail customers who are used to trading on regulated exchanges,¹ transparency is more important than in systems where institutional investors prevail. For retail investors, the need to seek out the most advantageous trading venue, in the absence of

¹ Italy has an estimated 10 million retail investors, including 3 million on-line traders.

economical and efficient means of publication of the data, could involve time and costs incompatible with satisfactory quality of execution. And this goes for the smaller intermediaries as well.

As to the instruments traded, when their “natural” (endogenous) liquidity is scanty, and where accordingly market makers must support liquidity, a high degree of transparency is not compatible with such provision of liquidity.

Italy, in view of its mass retail investment market, over the years has implemented legislation to ensure a high degree of transparency, requiring trading on regulated markets for equities and corporate bonds and placing stringent transparency obligations on the exchanges themselves (publication of pre- and post-trade information in real time and publication of aggregated data at the end of the trading day and monthly statistics free of charge). We cannot fail to note that despite the monopoly position of regulated exchanges in equity trading owing to this requirement, the cost of transactions in securities listed on Borsa Italiana are the lowest in Europe.

What is more, also for financial instruments not subject to the regulated exchange requirement, Italian regulators have instituted pre- and post-trade transparency requirements on organized trading systems (so called *Sistemi di Scambio Organizzato* or SSO).

Investors must be given the certainty that their dealers have the organizational capability to ensure best execution; that is, that they have information on all trade offers available in all the trading venues and can therefore chose the best. This can happen only if information is consolidated for all the venues where the security is traded.

Nor can we neglect the possible impact on capital costs to issuers of the reduction of liquidity that could stem from market fragmentation or lessened incentives for market-making in the less liquid securities. Reduced liquidity would make investors demand higher yields to compensate for the expected higher transaction costs; this has been demonstrated by several studies, which show that other conditions being equal, the more liquid bond issues offer lower yields (i.e. lower costs for the issuer).²

Another benefit of pre- and post-trade transparency is facilitating the work of market control authorities and thus enhancing investor protection and market integrity. The availability of information in real time makes possible, among other things, automatic identification of cases of market manipulation. The mere existence of these mechanisms is a deterrent.

Apart from the extension of mandatory transparency, let us note the importance of standardization in generating the real possibility of

² G. Chacko, “Liquidity Risk in the Corporate Bond Markets”, Harvard Business School working paper, 2005; C. Downing, S. Underwood and Y. Xing, “Is Liquidity Risk Priced in the Corporate Bond Market?”, Jones Graduate School of Management working paper, Rice University” (2005).

consolidating the information disclosed. A situation in which each country, or even every venue, had its own disclosure standards would be a serious obstacle or the source of substantial costs for any plan to consolidate information and for the very comparability of trading venues.

Such a situation must be overcome – better, nipped in the bud – by European standardization of the criteria for the publication of information, coordinated by the CESR at Community level; these criteria must be mixed, i.e. both market-led and public, as is being done in other sectors. ABI accordingly welcomes the CESR's 24 March call for evidence.

This position was first taken by ABI in 2002 in the work on the revision of the old Investment Services Directive, and we have reaffirmed it repeatedly in the course of the parliamentary discussion leading to approval of MIFID, as well as in the drafting of the implementing measures for the new Directive (level 2) and vis-à-vis the CESR in advising the Commission.

The Commission's call for evidence has opened discussion on an issue of the utmost importance for market transparency. It flanks the recent initiative of the CESR on the Consolidation of Market Transparency Data. The creation of an environment conducive to consolidation of data and extension of transparency in trading to the bond markets are two essential steps towards the creation of an efficient single European financial market.

Answers to individual questions

Q1: Do you have any comment on the proposed scope of the Report?

We agree with the Commission's document on the scope and purposes of the report, and in particular with the intention of not extending transparency requirements to unlisted shares, given their scant liquidity and the very limited trading by retail investors.

We also concur on the possibility of adapting the transparency requirements to the characteristics of the securities and the investors. As we shall make clearer further on, in our view there is a trade-off between transparency and liquidity for instruments with low natural liquidity. So if the intent is to safeguard the liquidity of securities that are less heavily traded owing to intrinsic features (low natural liquidity), one must allow lower levels of transparency. This trade-off is not found, however, for heavily traded instruments (with high natural liquidity). For these, that is, you don't have to sacrifice transparency for liquidity.

Q2: Do you consider this classification scheme to be sufficient for the purposes of the review?

We agree with the general classification of financial instruments that the Commission suggests. Calibration of pre- and post-trade transparency for each category should aim first of all at ascertaining the balance between quality and price (a direct function of the degree of transparency of possible terms for trades and those at which trades are actually made) and the supply of liquidity (where market-making mechanisms are not compatible with full pre-trade transparency or almost immediate disclosure of trades ex-post).

We do believe, however, that if it were decided to extend transparency requirements only to some categories of bonds, it might be hard for regulated institutions to determine precisely which instruments fall into the category subject to the regime.

Take, for example, the case in which transparency is extended only to trades in investment grade securities. The problem of determining which issues are so classified stems, for instance, from possible differences of judgment on the issuer/security by different rating agencies. Hence the intermediary could have trouble assigning a given bond to one category or another, generating uncertainty over the transparency requirements.

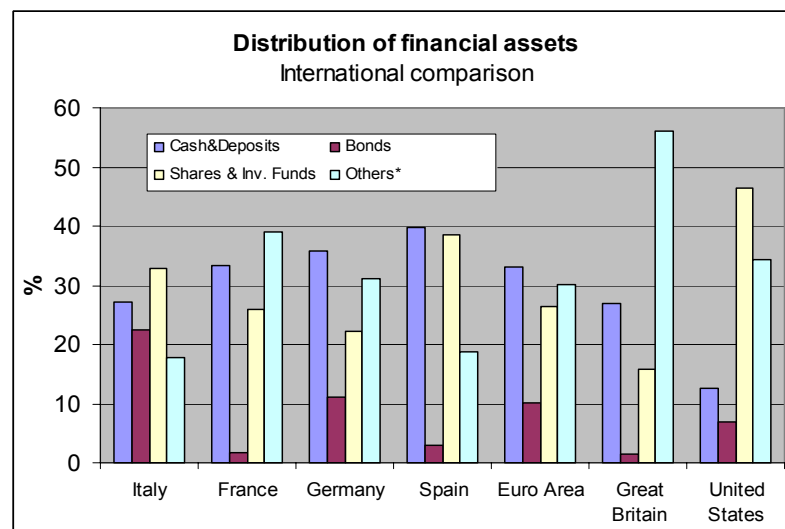
We do believe that it should be the competent authority to determine precisely which instruments fall into the sub-category subject to the regime, publishing a list of the securities subject to transparency obligations based on detailed objective criteria laid down at European level under which the relevant securities can be identified with no margin for error. Let us recall that this was the solution adopted for so-called "liquid shares" under MIFID, Article 27, the list of which is to be set by the individual national authorities based on uniform criteria fixed by Community law.

In the US TRACE system, the problem of divergent ratings between different agencies is solved by adopting the lower of the ratings assigned.

Q3: Do you consider there are possible policy rationales for mandatory transparency we have not listed?

We agree with the Commission's list of the principles that should guide legislation. In particular, we consider that great importance must be assigned to analysis of the level of transparency for financial instruments where the participation of retail investors is greatest. Let us recall that MIFID repeatedly underscores the need for a high level of investor protection (recital 2) and stresses that such protection must be differentiated according to investors' needs (recitals 31 and 41).

From this standpoint, comparative analysis of on the composition of retail investors' asset portfolios in Europe and the US is essential.



* insurance technical reserves; pension funds (households), others

Source: Banca d'Italia (Annual Report Year 2005)

The graph shows that for Italian retail investors bonds are a major component of total financial assets (22.4%). By contrast the lowest figure is that for the UK at just 1.5%, while the US is at an intermediate level (6.9%). These percentages are underestimated, however, in that the total includes deposits and cash. Excluding these, so as to count only investment in financial products, the portion of bonds in Italian retail portfolios rises to 30.7%, against 2% for Britain and 7.9% for the US.

Some studies have found that with the increase in post-trade transparency due to TRACE, transactions costs in the US have diminished, indicating that the two factors are linked.³

It would be interesting to compare the average transaction cost to retail customers, on which the EU Commission has begun a study and released some draft results, with the degree of transparency in effect in the various European countries and the US, to see empirically how the three variables may be related (retail investment, transaction cost, transparency).⁴

On investor protection, in addition to the three rationales set out by the Commission, in our view it is significant that transparency facilitates the work of market authorities and thus strengthens market integrity and investor confidence.⁵

If regulatory intervention were to reduce transaction costs, one would expect greater participation in the bond market by investors previously held back by the relatively high incidence of trading costs on yields. This effect would come under the general aim of increasing investor participation. A number of studies finding a reduction in transaction costs for corporate bond trading in the US after the introduction of TRACE reach analogous conclusions.⁶

³ Bessembinder, H., Maxwell, W., Venkataraman, K., 2006, "Optimal market transparency: Evidence from the initiation of trade reporting in corporate bonds", *Journal of Financial Economics*, forthcoming; Edwards, A., Harris, L., Piwowar, M., 2005, "Corporate Bond Market Transactions Cost and Transparency", *Journal of Finance*, forthcoming; Goldstein, M., Hotchkiss, E., Sirri, E., 2006, "Transparency and liquidity: A controlled experiment on corporate bonds", *Review of Financial Studies*, forthcoming.

⁴ See Annex III, "Cost of execution of retail equity trades in Europe in 2005", in the "Draft working document on post-trading", released May 2006 by the EU Commission as part of the CESAME.

⁵ On this particular point see Edwards, A.K., 2006, "Corporate bond market microstructure and transparency: The US experience", *BIS Papers No 26*, p. 35.

⁶ Edwards, A., Harris, L., Piwowar, M., 2005, "Corporate Bond Market Transactions Cost and Transparency", *Journal of Finance*, forthcoming.

Q4: Do you agree with our proposals for prioritisation of the review?

We agree with the priorities set in the Call for Evidence. At the same time we note that supranational bonds and emerging market bonds, which are categories in their own right in the classification on pp. 3-4, are not expressly considered among the instruments to analyse (p. 6).

As it is not clear whether the Commission has implicitly included them in the broader general category of government bonds, which are specified in the list on p. 6, and given the significant presence of retail investors in these two categories of bond as well, it is important that the Commission explicitly includes them among the financial instruments for analysis.

Q5: 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?**

The lack of mandatory transparency on bonds, unlike shares, could cause problems for intermediaries in complying with the stringent best execution standards laid down by MIFID, which as we know will apply to all financial instruments.

Let us cite two practical examples in which the absence of the obligation to make pre- and post-trade data available to the public at a reasonable cost could give rise to problematic situations.

First, as to lack of pre-trade transparency, consider an order taker that participates indirectly via various brokers in two or more execution venues for a given security and wants to maintain control of the trading process. Without up-to-date information on offers and quotes in the various venues, such an order taker could find it impossible to identify the venue which, order by order, offers the best terms for execution (as it does not participate directly). Or else it will have to acquire this information, but at a higher cost than the "commercially reasonable" price that MIFID institutes for equity markets.

As to post-trade transparency, it could be difficult or quite costly for the intermediary to monitor "execution quality" when it reviews its execution policy.

Finally, lack of transparency, in fact, could seriously hamper retail investors' direct participation in the market and compromise their ability

to monitor their brokers' activities and compliance with best execution requirements, consequently widening the gap between "informed" and "uninformed" investors. In general, mandatory transparency adapted to the type of security (excessive transparency could produce a market failure, i.e. no trading, for securities that need liquidity support) will bolster above all the confidence of investors who are at an informational disadvantage (as a rule, retail investors), and thus favour their participation.⁷

Q6: 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?

In general, it must be admitted that the increased costs of extending mandatory transparency are not due so much to technological costs as to the position risk to which dealers are exposed in disclosing their quotes, and to a lesser extent their trades, to the market.

Moreover, if the Commission decided to extend transparency requirements, in our opinion software and technology for the financial industry would be promptly provided at competitive prices by the countless competing IT suppliers. In fact, technological solutions are already being devised to handle the obligations associated with MIFID for equities.

b. render mandatory transparency unnecessary?

It is improbable that greater transparency can be attained exclusively through non-regulatory initiatives. Most instructive in this regard is the US experience, where the regulator, in order to ensure satisfactory trading transparency, elected to undertake its TRACE regulatory initiative.

The best solution could be a transparency regime decided by the regulator but graduated and designed "in concert" with the industry. For example, post-trade transparency could be made mandatory in quote-driven markets, but with a delay graduated accorded to the liquidity of the instrument: less liquidity, a longer delay.

Q7: To what extent are non-equity financial instruments different from equities so that lower levels of mandatory transparency in those markets may be justified?

⁷ Madhavan, A., 2000, "In Search of Liquidity in the Internet Era", Ninth Annual Financial Markets Conference of the Federal Reserve Bank of Atlanta, p. 6.

In our opinion the optimal level of transparency in bond markets may differ even quite considerably not only from equity markets but also internally, between different types of bond.

Let us mention some of the key differences:

Price. Bonds generally display less price volatility than listed shares, with the exception of a few types of bonds or sudden downgrades of issuers; further, corporate bond prices generally depend on those of risk-free government bonds with similar characteristics (rate, maturity, etc.), plus a premium for issuer risk.

Complexity. As the IOSCO Report acknowledges, in recent years bonds – and especially corporate bonds issued by financial institutions – have taken on more complex structures, generally with the addition of derivative components and/or asset backing, to serve investors' needs.⁸

Investors. Most investors, especially retail investors, have a "buy and hold" strategy for bonds. Unlike equity investment (where on-line trading has developed significantly), for bonds day trading is extremely rare. Direct participation of retail customers in the secondary bond market is thus very limited indeed compared with the equity market, as is recognized in the IOSCO Report already cited.

Liquidity. Liquidity is concentrated in the period immediately following issue, save for very large-volume issues such as government and major corporation bonds. This is due in part to the typical buy-and-hold strategy of investors. The primary bond market is thus of fundamental importance. And bonds are also strictly related with the credit derivative and repo markets, to which a part of the liquidity (and the risk) of the secondary bond market is transferred.

Trading. The generally thin liquidity of the secondary corporate bond market impacts on trading, which is conducted mainly OTC on quote-driven electronic systems for the more liquid issues and via indicative quotes from the main data vendors and telephone deals for the less liquid ones. Trades are generally fairly infrequent but for very large amounts, the typical characteristics of a wholesale market. In such a market, dealers/market makers are crucial, trading on own account and taking position risk. This type of trading is another distinctive feature with respect to the markets in listed shares, which are usually order-driven, the dealer merely transmitting the customer's order to the exchange and taking no significant risk.

Q8.: 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?

⁸ IOSCO, "Transparency of corporate bond markets", 2004.

The necessary data, in our view, can be supplied by the ECB, national authorities, and the main operators in markets (regulated markets, MTFs, leading dealers and information providers).

Q9: Are there academic or institutional papers or ongoing work that should be considered in preparing the Report not included in our bibliography?

In addition to the Commission's ample bibliography, let us suggest the following.

Not cited:

- Biais, B., Green, R., 2005, "The microstructure of the bond market in the 20th century", working paper, New York Stock Exchange
- Chakravarty, S., Sarkar, A., 2003, "Trading costs in three U.S. bond markets", *Journal of Fixed Income* 13, 39-48
- Chen, L., Lesmond, D., Wei, J., 2002, "Bond liquidity estimation and the liquidity effect in yield spreads", working paper, Michigan State University
- European Central Bank, 2004, "The Euro Bond Market Study", Frankfurt am Main
- Edwards, A.K., 2006, "Corporate bond market microstructure and transparency: The US experience", *BIS Papers* No 26, 31-38
- Financial Services Authority, 2006, "Trading transparency in the UK secondary bond market. Feedback on DP05/5", *Feedback Statement* 06/4
- Green, R.C., Hollifield, B., Schüroff, N., 2004, "Financial Intermediation and the Costs of Trading in an Opaque Market", working paper, Tepper School of Business, Carnegie Mellon University
- Hendershott, T., Jones, C.M., 2005, "Island Goes Dark: Transparency, Fragmentation, and Regulation", *Review of Financial Studies* 18, 3, 743-793
- Hong, G., Warga, A., 2000, "An empirical study of bond market transactions", *Financial Analysts Journal* 56, 32-46
- Hotchkiss, E., Warga, A., Jostova, G., 2005, "Determinants of corporate bond trading: A comprehensive analysis", working paper, Boston College
- Kalimpalli, M., Warga, A., 2002, "Bid-ask spread, volatility and volume in the corporate bond market", *Journal of Fixed Income* 12, 31-42
- Schultz, P., 2001, "Corporate bond trading costs: A peek behind the curtain", *Journal of Finance* 56, 2, 677-698
- Warga, A., 1992, "Bond returns, liquidity and missing data", *Journal of Financial and Quantitative Analysis* 27, 4, 605-616

Cited, but needing updating:

- Bessembinder, H., Maxwell, W., Venkataraman, K., 2006, "Optimal market transparency: Evidence from the initiation of trade reporting in corporate bonds", *Journal of Financial Economics*, forthcoming
- Edwards, A., Harris, L., Piwowar, M., 2005, "Corporate Bond Market Transactions Cost and Transparency", *Journal of Finance*, forthcoming
- Goldstein, M., Hotchkiss, E., Sirri, E., 2006, "Transparency and liquidity: A controlled experiment on corporate bonds", *Review of Financial Studies*, forthcoming.
- Madhavan, A., Porter, D., Weaver, D., 2005, "Should securities markets be transparent?", *Journal of Financial Markets*, 8, 265-287.

Q10: What conclusions do you draw from the existing academic debate and the work being conducted by other interested parties?

Microstructure theory does not offer unambiguous conclusions on the impact of transparency on liquidity or, in general, on market quality. The optimal level of transparency is very hard to determine. The Table below shows the varying conclusions of the different theoretical models, empirical studies and experiments.⁹

TABLE 3: MARKET DESIGN
Panel C: Transparency

Form of transparency	Theoretical analyses	Empirical analyses	Experimental analyses
Ex ante	Better information reduces adverse selection and hence spreads (Pagano and Roell (1996)).	An increase in ex-ante transparency attracted more limit orders in the NYSE book, resulting in greater displayed liquidity (Boehmer, Saar and Yu (2004)), but on the Toronto Stock Exchange it was followed by an increase in spreads (Madhavan, Porter and Weaver (2000)).	Pre-trade transparency narrows spreads (Flood et al. (1999)).
Ex post	Trade disclosure enhances risk sharing (Naik et al. (1999)).	In the London Stock Exchange, dealer spreads were not affected by changes in the trade disclosure regime (Gemmill (1996)).	Opening spreads are larger, but subsequent spreads tighter, when ex-post transparency is enhanced (Bloomfield and O'Hara (1999 and 2000)).

Optimal market structure cannot be determined without reference to the natural liquidity characteristics of the instrument. Securities that are

⁹ Table 3C in Biais, B., Glosten, L., Spatt, C., 2005, "Market Microstructure: a Survey of Microfoundations, Empirical Results and Policy Implications", *Journal of Financial Markets* 8, 2, 217-264.

“naturally” (intrinsically) more liquid – with large capitalization, a large float, short holding periods and a constant flow of many orders – can be traded in market structures different from the “naturally” less liquid (low capitalization, low float, long holding periods, low and variable frequency of buy and sell orders).

The model developed by S. Grossman and M. Miller (1988) [“Liquidity and Market Structure” *Journal of Finance* 43, 617-637] has been confirmed empirically in a number of studies.¹⁰ The model calls for a participant trading on own account (dealer, market maker or specialist) to increase liquidity when expected volume is low, while an auction system is better when expected volumes are relatively high. The underlying intuition is that when expected volume is large, buy and sell orders can match independently with no need for an intermediary to perform dealership functions.¹¹ But when volume is low, demand and supply flows will have trouble meeting independently, so an institution to perform this matching function will be needed.

So where there is high natural liquidity no dealer is needed to produce a market of adequate quality in terms of microstructure. This is demonstrated in practice by the preponderance of pure order-driven markets in continental Europe that have narrow bid-ask spreads and good price efficiency without any market makers. Where there is low natural liquidity, however, the problem of sustaining market liquidity arises. Liquidity can come from a flow of limit orders from the market as a whole or can be supplied by an intermediary assigned to do so (dealer, market maker, specialist). In the former case, transparency increases liquidity because it encourages the posting of limit orders. In the latter it can diminish liquidity by aggravating the dealers’ problems of adverse selection and inventory management.

For less liquid securities (shares and bonds alike), and in any case whenever an operator (dealer, market maker, specialist) that systematically supplies liquidity is required, there is a trade-off between transparency and liquidity. The problems of informational asymmetry and inventory management that dealers face are incompatible with high mandatory transparency, neither pre-trade (where it applies generally only to the best bid/offer) nor post-trade (as the dealer needs at least the time to rebalance the inventory after each trade). Without such opacity (which does of course need to be graduated to prevent dealers from reaping excessive monopoly profits), dealers will not have the incentive to take part in the market; and if they withdraw, the market could simply fail if natural liquidity is too low.

¹⁰ Among others, Huang and Stoll (1996), *Journal of Financial Economics*; Mimalendran and Petrella (2003), *Journal of Banking and Finance*; Anand and Weaver (2004), *Journal of Financial Markets*; Kumar, Venkataraman and Waisburd (2006), *Journal of Financial and Quantitative Analysis*.

¹¹ The absence of an institution assigned to supply liquidity implies lower trading costs for consumers of liquidity.

It is worth noting that dealers face especially large position risks on large-volume trades, which derive from the combined effect of adverse selection (in a word, the risk of dealing with better-informed traders) and inventory (the risk of the market moving against one's portfolio holdings).

Thus a high degree of mandatory transparency could be harmful to dealers, heightening their position risk exposure. And in fact a good number of countries allow exceptions to mandatory pre- and post-trade transparency for large-value equity and/or bond transactions; and the MIFID itself has such a provision for pre trade and post trade transparency.

In short, the literature does offer solutions (order-driven markets with transparency for high-liquidity securities) while at the same time identifying two practical problems.

- determining the natural level of liquidity below which the intervention of an intermediary in support is necessary;
- determining the proper level of mandatory market transparency to protect less informed investors without discouraging intermediaries from supplying liquidity.

The answers cannot come from past studies, however. Their findings are not concordant; and, more important, the reaction of market agents to modifications of the mandatory transparency regime will have effects that are not theoretically predictable, in that they involve a large number of persons with different objective functions and constraints.

To avoid the substantial risks of altering market arrangements with partly unforeseeable consequences, one possible way of proceeding is as follows:

- conduct a measurement, with a shared, uniform methodology, of the present level of quality of markets in Member States, to assess the need for regulatory intervention,
- if necessary, phase in the regulatory changes, with pilot projects on sub-sets of securities, patterned after the NASD procedure (see below), permitting swift assessment of the effects of the changes.

The case of the United States is most instructive in highlighting practical difficulties and determining optimal transparency thresholds for the bond market, as well as most interesting for the procedure followed.

In July 2002 the National Association of Securities Dealers began a program to increase post-trade transparency in the secondary corporate bond market. Starting 1 July, data on trades were released only for a select subset of bonds (issues with investment grade ratings and volume of at least a billion dollars). The publication of data on other bonds was to be phased in later, depending on the findings of a series of studies on the likely impact of transparency on market quality.

The NASD commissioned three independent economists to perform the studies: Michael Goldstein of Babson College, Edith Hotchkiss of Boston College and Erik Sirri of Babson College. With their assistance the NASD designed an experiment to evaluate the impact of transparency on the liquidity of the smaller issues of bonds. The sample consisted of 120 issues (90 more heavily traded and 30 less traded) rated BBB and with issue volume of between \$10 million and \$1 billion. Starting 14 April 2003 the TRACE reporting system began to publish data on trades completed (post-trading or trade transparency). The impact of post-trade transparency was evaluated using two methodologies: event study and matched pairs. The event study compared the indicators of market quality before and after the introduction of trade transparency (the respective periods were 8 July 2002 to 4 April 2003 and 21 April 2003 to 27 February 2004). The matched pairs compared the market quality indicators estimated for issues to which TRACE was applied (the sample of 120 bond issues) with a control sample of comparable issues not subject to TRACE.

The results show that post-trade transparency certainly did not worsen market quality and in a number of cases improved it. The spread on bonds subject to post-trade transparency narrowed, holding the other relevant factors equal (duration, volume, amount in circulation, etc.), and the effect was greater for intermediate-sized trading (50-250 bonds per trade with average value of \$37,500). For little-traded bonds (0.3 trade a day, 86.2% of business days with no trades at all, an average of 11.9 days between trades), the effect of transparency was not statistically significant. That is, the hypothesis that ex-post transparency damages the less liquid securities was rejected.

The findings of these US studies on TRACE are most important, but they obviously depend on the context and on other variables specific to the US market (the initial level of transparency, the market's degree of development, participants, instruments available) as well as on the criteria for sample selection (Goldstein et al. (2006), for instance, took only BBB-rated bond issues with issue value of \$10 million to \$1 billion).

In view of the structural differences from the US, what should interest us is not so much the results of the US studies on the impact of TRACE as their methodology. At least two aspects of the NASD process are most interesting: the gradual shortening of the maximum time period for release of data on trades and the use of pilot studies on the effects of transparency for a subset of bonds with low natural liquidity. In particular, we could conduct pilot projects with experiments similar to those of the NASD to evaluate the effects transparency on the various market segments.

Q11: In your view, how applicable is the academic or institutional literature concerning transparency in the cash equities markets to the present discussion?

Studies on equity markets must be evaluated carefully, taking into proper account the differences between share and bond markets. As a general rule, the relevance of studies in different institutional frameworks from those subject to regulatory intervention is quite limited. The practical effects of a rules change on market quality depend on the reaction of market agents. This in turn depends on the concrete behavioural incentives in place. As the structure of the incentives governing market participants' conduct are specific to a given reality, it is very unlikely that the findings of studies performed in one institutional context will prove to be good predictors of the results in a different context.

Q12: 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 experience in the US?

The possible implications of the TRACE experience must be drawn with the utmost of caution, for two reasons. First, the US bond market differs significantly from the European in initial degree of transparency, degree of development, participation, and instruments. Second, within the EU situations vary significantly, so one cannot simply compare the European situation with the American.

As noted earlier, in fact, in some European markets direct retail investor participation is very scant (in the UK), while in others it is large-scale (Italy). This lack of participation could well be due partially to the lack of transparency vis-à-vis retail investors or to higher trading costs.

Accordingly, we should rely on the results of the TRACE experience to a very limited degree only and instead deepen our understanding – including for purposes of comparison with the US – of the European market and the single national Member State markets. A possible method of inquiry and comparison could be to consider the US situation, in particular the level of direct participation by retail investors and transaction costs, as a benchmark to gauge the evidence from European markets.

Special attention should be given to pre- and post-trade transparency and transaction costs in countries where direct retail participation is significantly more or less extensive than in the United States.

Q13: 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?

We agree with the view expressed in the Commission's paper. The bond markets are very closely integrated at Community level and globally, so that extending mandatory transparency only in some countries could produce a non-level playing field and facilitate regulatory arbitrage. See answer to question 14.

Q14: 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?

Market forces alone are not always capable of attaining appropriate solutions, which in this particular case means ensuring an optimal degree of transparency. The US experience is a case in point: the regulator felt the need for a specific project, TRACE, to guarantee trading transparency.

Moreover, without immediate intervention by the Community legislator there is the risk of consolidating the economic positions of a small number of private parties, who could thus block further change; another risk is that some Member Countries could enact their own transparency rules pursuant to recital 46 of MIFID, thus tilting the playing field among intermediaries, fragmenting the single market on a national basis and prompting regulatory arbitrage.

Precisely in order to foster full harmonization among the various EU financial markets the Commission, in its report, should call for abrogating the power of individual Members to independently extend mandatory transparency, or at least for requiring that such a decision be solidly motivated and subjected to cost/benefit analysis.

As the extension of mandatory transparency would constitute, de facto, a relevant phenomenon with the features of so-called "gold plating", such a decision should observe the conditions laid down in Article 4 of the Directive for Member State's level 2 provisions imposing additional requirements over and above those of Community law.

Q15: 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?

We concur with the document as regards the possible transparency regimes the Commission should examine.

Q16: 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?***

The Italian banking industry concurs with the idea of mandatory transparency limited to government and investment-grade, high-yield and ABS bonds only. However, this regime should also cover supranational bonds and emerging market bonds (see answer to question 4).

As to pre-trade transparency, we judge that of extending a mandatory transparency regime like that of MIFID positively, but limited to regulated markets and MTFs. Mandatory pre-trade transparency should not be instituted for systematic internalizers in the bond market (third option, para. 5.1, p. 9).

As noted above (question 10), a good many studies, including a recent one by the FSA, have pointed out the risk that instituting mandatory pre-trade transparency could heighten the position risk exposure of dealers, driving some out of the market and thus reducing competition between venues, leading overall to less competitive quotes.¹²

However, we believe that exchange operators and MTFs should publish, in anonymous form and on commercially reasonable terms, information on the prices and volumes that system participants are willing to trade at. Markets and MTFs, in fact, have no position risk to mitigate. In Italy, for that matter, they are already subject to this obligation for all listed instruments.

As to post-trade transparency, in our view the best of the options set out by the Commission is the introduction of a MIFID-style system (fourth option, para. 5.2, p. 9) requiring the publication of data on the prices and volumes of trades concluded.

However, we also judge to be of interest the idea of a TRACE-type system, with European consolidation of information and a minimum delay before publication. However, we think this possibility needs to be subjected to careful cost/benefit analysis; among other things, we need to determine which persons should bear the direct costs of implementing the system, estimate the likely implementation costs for intermediaries,

¹² FSA, "Trading transparency in the UK Secondary Bond Markets", July 2006.

determine the institution that should realize and operate the system, and evaluate the interaction with the transaction reporting system laid down in Article 25 of MIFID.