



Bundesverband Investment
und Asset Management e.V.

Contact:

Dr. Magdalena Kuper
Phone: +49.69.154090.263
Fax: +49.69.154090.163
magdalena.kuper@bvi.de

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Mrs. Natalie de Basaldua
Head of Unit Markt.G.3
GD Internal Market and Services
European Commission

B-1049 Bruxelles / Brussels
BELGIUM

Call for Evidence concerning 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

Dear Mrs. de Basaldua,

BVI¹ gladly takes the opportunity to respond to the Call for Evidence on potential needs for enhanced transparency for transactions in financial instruments other than shares issued in preparation of a respective report to the European Parliament and the Council. We would like to thank the EU-Commission for an involvement of the industry at this early stage as well as for the perceivable openness for suggestions as regards the analytic concept of the report.

General remarks

We appreciate the Commission's view that the options for future regulatory measures to be taken into regard are not limited to full applicability or non-applicability of MiFID transparency provisions. Indeed, the particular features of secondary bond and derivative markets call for a rather different treatment in relation to equity trades and might require further differentiation according to specific classes of financial instruments.

¹ BVI Bundesverband Investment und Asset Management e.V. represents the interest of the German investment fund and asset management industry. Its 83 members currently manage more than 7,600 investment funds with assets under management close to € 1,200 bn. The units of these funds are held by some 15 million unit holders. Mandates for portfolio management services provided by our members comprise assets in excess of € 150 bn. For more information, please visit www.bvi.de.

Director General:
Stefan Seip
Managing Director:
Rüdiger H. Päsler
Rudolf Siebel

Eschenheimer Anlage 28
D-60318 Frankfurt am Main
Postfach 10 04 37
D-60004 Frankfurt am Main
Phone: +49.69.154090.0
Fax: +49.69.5971406
info@bvi.de
www.bvi.de



First of all, it must be noticed that the characteristics of bonds' payoffs attract different types of investors than investments in shares. Except for specialized market sectors like derivative securities, bond issues are placed mainly with institutional investors like fund managers, insurance companies and pension funds who largely follow buy-and-hold strategies. These investments severely reduce the level of activity in the secondary bond market meaning that the liquidity is fairly low compared with the stock market. Moreover, differences between specific bonds are less distinct than differences between shares. Frequently, investors wish to trade certain categories of bonds (e.g. A-rated corporate bonds with a certain maturity date) rather than certain bonds which, in turn, evokes less concentration in terms of capitalization and trading.

Trading in bonds also tends to follow different rules than transactions pertaining to shares. The major divergence is caused by the fact that EU-bonds, although in the majority listed on regulated markets, are hardly ever traded via these venues. Significant proportions of secondary market bond trading take place over the counter or via electronic trading platforms, either of which may be scheduled for inter-dealer (B2B) or dealer-to-customer (B2C) relationships. Also in this respect, different rules apply to trades in securitized derivatives which are often executed on exchange.

On electronic trading platforms, three different trading methods apply: (1) Quote-driven systems where market makers are committed to fulfil price quoting obligations on a continuous basis, (2) Order-driven process where anonymous buy and sell orders placed by users are automatically executed when matching orders are entered at the same price, and (3) Request-for-Quotes (RFQ) which enables investors to request and compare indicative prices of several dealers before deciding where to execute a transaction. Quote- and order-driven models are features of B2C platforms, whereas RFQ model is offered solely in B2B relationship.

The experience of asset managers indicates that only the more liquid asset classes are eligible for e-trading. Hence, quote- and order-driven systems constitute a nearly exclusive domain of liquid government bonds, while, in contrast, almost the entire High Yield and Asset Backed Securities markets trade OTC via voice only. Electronic trades in corporate bonds are mostly executed via the RFQ model, and large size trades or trades in less liquid securities are done by voice.

As a consequence, participants in bond markets rely mainly on bilateral non-anonymous communication, while stock markets often involve multilateral anonymous communication process. In face of this fundamental difference, arguments for greater market transparency drawn from possible effects on efficiency of price formation mechanisms on regulated markets do not suit the characteristics of bond trades. On the other hand, it must be taken into account that the already fragile level of liquidity in bond market might be seriously impaired by inappropriate transparency regulations. This might be



the case in narrow market segments where liquidity providers might be unwilling to meet the risk of large-size trades if transparency obligations force them to disclose details of the transaction to the market and thus, to militate the chance of unwinding the trade in the inter-dealer relationship.

Hence, we urge the EU-Commission when drafting the report to abstain from hasty conclusions on the basis of stock market regulation and to reach any decision for regulatory action on basis of proper cost-and-benefit analysis. In particular, the examination of transparency in bond markets in the run-up to the report should be conducted in accordance with the aforementioned peculiarities and thus, should specifically focus on sectors with detectable market failure or those requiring a higher level of investor protection because of significant involvement of private customers. Furthermore, it should not strictly confine to the issues of pre- or post-trade-transparency, but rather provide a comprehensive analysis of deficiencies in price formation due to insufficient information available to the market.

In our view, the need for further regulatory intervention can be perceived in three areas:

- Asset Backed Securities market
- Market for structured notes (certificates/securitized derivatives)
- Market for corporate bonds.

In other areas of the market, we are confident that appropriate levels of transparency can be reached by means of competitive market pressure on basis of advanced technological development.

Specific Comments

Taking the view of the asset management industry representing a significant group of institutional investors, we would like to respond to the following questions raised in the consultation paper:

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

In general, we welcome the open and unbiased structure of the report. However, when conducting the preparatory analysis, we think it feasible to pay particular attention to markets in financial instruments in which there are reported deficiencies or even failures of market mechanisms. We will address our concerns with regard to such market areas in the later sections of our comments.



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

In the first place, we miss a category under which securitized derivatives on stocks, indices and currencies might be taken under closer scrutiny with respect to transparency level of relevant markets. As, in our view, derivative securities should play a prominent role in the preliminary analysis because of insufficient level of investor protection to be found in these markets, we suggest listing derivative securities as a separate category of financial instruments which might be further classified as follows:

- Derivative securities
 - Derivative leverage products (warrants, knock-out products)
 - Derivative investment products (investment certificates on stocks, indices, currencies, commodities and interests, reverse convertibles)

Moreover, since Asset Backed Securities are considered cash bonds in the market practice, we suggest subsidizing the whole ABS-block under the cash bond category. Similarly, covered bonds are rather a sub-group of cash bonds than of ABS. Hence, they should not be classified as ABS, but rather, due to their different nature, be listed in a separate section. Consequently, in the area of cash bonds the following classification scheme would apply:

- Cash Bonds
 - Asset Backed Securities
 - Mortgage-Backed Securities (MBS)
 - Collateralised Debt Obligations (CDOs)
 - Other ABS (e.g. credit cards, auto loans and leases)
 - Covered Bonds (e.g. Pfandbriefe)

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

We agree with the proposition to focus regulatory efforts on areas with potential concerns in terms of investor protection. In particular, we share the view that UCITS should not be in the focus of the analysis due to NAV-based rules of fund valuation laid down in the UCITS-Directive. As concerns other market areas, however, we do not entirely concur with the conclusions drawn from the said premise having regard to market realities.

In our opinion, the lack of reasonable transparency with respect to price formation and development mechanisms is particularly evident in the area of derivative securities. This section of the bond market has rapidly evolved during the last few years in most EU-Member States, notably Germany, but also in France, Austria, Spain, etc., where derivative securities are broadly distributed to retail investors. Determination of prices for this class of



securities is left to the monopoly of issuing banks with no control possibilities on the part of consumers due to complete lack of transparency with regard to components and mechanisms of price formation. Moreover, in cases of miscalculation where the bank is not in a position to make desired profits, transactions in securitized derivatives can easily be cancelled to the detriment of investors. The mechanisms relevant to the functioning of certificate markets are explained in more detail in our response to question 5a.

In addition, the analysis of bond markets should put more weight on areas with conceivable market dysfunctions being attributable to transparency deficits. Obvious examples of such market sectors are, in our view, markets for ABS and some categories of corporate bonds where post-issuance price information problems are acute.

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

As already indicated, we see major problems in the evolving market for derivative securities. These financial instruments tend to appear in different designs and shapes, but can be basically reduced to the categories of investment (e.g. certificates) and leverage (e.g. warrants), see above.

As it stands, pricing of securitized derivatives is the sole privilege of issuing banks. This principle applies not only to off-exchange distribution, but also to trades on exchange where the respective bank usually holds the monopoly on market-making function. For example, the rules of EUWAX², the market-leading platform for trades in derivative securities in Germany, permit only execution of trades within the bid-ask spread determined by the issuer or respectively authorised market-maker. As the EUWAX-rules also prohibit short sales in derivative securities, no price correction mechanisms can be applied in order to ensure that the prices offered by issuers correspond with the fair value of respective underlying.

Consequently, issuing banks are free to include healthy profit margins when calculating prices of derivative securities. As a rule, the highest margins are being attributed to initial price offerings with significant margin reductions taking place towards the end of maturity period when banks start to pay off their investors. Apart from simply structured products like certificates on major performance indices, where the high competition among issuing banks provides for product comparability and near-adequate pricing, average retail investors have no means to control or at least comprehend the price-building mechanism applied to certificates. Still, this severe lack of

² For further information see www.euwax.de



transparency is aggravated in cases where the issuer also determines the price of the underlying.

In addition, under the rules of EUWAX as well as other trading platforms, issuing banks are entitled to annul transactions in certificates which are executed at prices “clearly diverging from market prices”. As determination of market prices is effectively dictated by issuers, there are reported cases in which banks drastically changed the quoted price of a security to allow for rescission of less profitable trades. Thus, applications for rescission which can be filed up to 24 hours following the execution of a trade eliminate even the slightest risk of missed profits due to incorrect price calculation. This practice appears intolerable in light of the fact that the market for derivative securities is frequented by retail investors and has already reached a size of Euro 100 bn in Germany.

With regard to ABS market, there are pressing problems concerning post-issuance investor information. Some ABS, in particular CDOs, do not publish periodical investor reports pertaining to the issued tranches of securities, even though these are listed on regulated markets. Also, in spite of ad-hoc rules of the Market Abuse Directive³, there is no clear obligation to disclose all information directly affecting market prices of listed securities (e.g. portfolio information, significant changes of operating figures, material shortfalls). Similar problems affect corporate bonds of issuers whose shares are not listed on regulated markets.

Question 5b: *To what extent do you consider there to be evidence that mandatory pre- or post-trade transparency would solve any of those problems?*

Considering markets for derivative securities, pre- or post-trade transparency in the narrow sense would not be sufficient. The major problem concerns rather the complete lack of information with regard to the price forming mechanism. Hence, disclosure of pricing components with a separate specification of the effective margin is needed in the information materials to be provided to investors.

Also, transparency deficiencies affecting ABS and corporate bond markets call for regulatory action in terms of general market information. In our opinion, much can be done by introducing periodic reporting obligations with specific regard to securities listed on regulated markets. Moreover, a consequent extension of ad-hoc communication requirements to cover inside information directly concerning the issued securities would also help to provide investors with reliable indicatives for price-sensitive issues.

³ Directive 2003/6/EC of 28 January 2003 on insider dealing and market manipulation (market abuse)



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

- a. *contribute to a relatively inexpensive extension of mandatory transparency?*
- b. *Render mandatory transparency unnecessary?*

In relation to some other sectors of the bond market like corporate bonds or emerging market bonds, the level of trade transparency is not entirely sufficient. Difficulties in price assessment for buy-side market participants arise mainly from the fact that price quotes are of purely indicative nature and provided by brokers only if explicitly contacted by the client or through data vendors at a cost.

Nevertheless, we see substantial improvements in this respect due to rapid development of market technologies. The recent evolvement of electronic trading platforms such as MarketAxess which involve several dealers and offer prices remaining firm for a specified period of time is a big step forward on the way to enhancing market efficiency. Over time, we may expect further growth of electronic trading and communication means with beneficial effects on transparency and inter-dealer competition. Hence, in these terms we are confident that the market itself will provide for appropriate responses to residual transparency deficits on basis of continuing technological development.

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?*

Differences between equity and bond markets are explained in detail under the section "general remarks". Basically, bond markets comprise much broader range of products which may differ in terms of activity, but altogether generate markedly less trade turnover. Hence, bond markets rely to a large extent on dealers willing to supply liquidity in order to ensure trade execution. Under these circumstances, too high transparency might increase the risk of unwinding purchases in the B2B relationships and thus, lead to enhanced withdrawal of capital from the market. Moreover, direct participation of retail investors in the bond market is very low which mitigates potential concerns for investor protection.

Another significant difference is the level of volatility which tends to be much higher in equity than in bond markets.



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?*

With reference to transparency deficits identified in our response to question 5, EU-level action is highly desirable. Due to the advancing integration of EU financial markets and increasing cross-border trading activities of European investors, only a harmonised approach to market transparency may establish a comprehensive and comparable basis for investment decisions. The same rationale applies with regard to potential pre- and post-trade transparency problems identified by other stakeholders. In the market for ABS, material improvements can be reached by adjustment of the relevant provisions of Market Abuse Directive as well as other existing EU-rules.

In terms of corporate bonds, we opt for a light regulatory approach providing for post-trade transparency in a way similar to the TRACE system existing in the US market.

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?*

As explained in our response to question 6, we believe that minor problems in terms of market transparency still occurring in certain areas of the bond market can generally be resolved on basis of increasing competition and purposeful use of technological resources. Self-regulation initiatives among market participants may also contribute to the swift achievement of proper transparency level.

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?*

In our opinion, the four options for action proposed by the EU-Commission are appropriate. Nevertheless, we would once again like to point out that mandatory provisions on transparency should remain ultima ratio and must be preceded by an in-depth analysis with regard to corresponding detriments and benefits.



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?*

As specified in our responses to questions 5b and 13, lacks of transparency in respect of derivative securities and ABS market cannot be eliminated solely on basis of pre- and post-trade consideration. A broader approach to transparency is needed which includes product and issue-based concerns and provides for a reasonable level of information regarding price formation and price development mechanisms.

As regards the issue of corporate bonds, we request the EU-Commission to analyse the pros and cons of introducing a TRACE-related transparency system in the EU. Outside this area, however, the bond market appears generally capable of dealing with any upcoming deficiencies either by relying on continuing market development or by subjecting itself to self-regulatory measures agreed on voluntary basis by market participants.

We hope that our comments are helpful for the Commission's preparation of the Report on pre- and post-trade transparency in the EU bond market and remain at your disposal for any questions you may have.

Yours sincerely

BVI Bundesverband Investment und Asset Management e.V.

Rudolf Siebel LL.M

Dr. Magdalena Kuper