

Call for Evidence

Pre and post-trade transparency provisions of the Markets in the Financial Instruments Directive (MiFID) in relation to transactions in classes of financial instruments other than shares

Contribution provided by CONSOB

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

The EC Call for Evidence (hereinafter “The Paper”) clarifies that the issue of transparency on financial instruments other than shares does not require consideration of a MiFID-style or nothing approach. On the contrary, the Paper indicate that the reference to the extension of the transparency regime envisaged in MiFID should be read in terms of analysis of the characteristics of the instruments and the markets on which they are traded to identify the adequate transparency regime for such financial instruments.

CONSOB agrees on such approach and scope of the work undertaken. In light of the regulatory framework and experience in the field of pre and post-trade transparency applying to bonds in Italy, CONSOB is very supportive of the initiative to start working on an adequate transparency regime for bonds at a European level which takes into account the specific nature of fixed-income markets. This would reasonably involve not only the possibility to have a transparency regime which is different to the one prescribed by MiFID for shares but also more than one transparency regime for different instrument classes.

In fact, fixed-income markets have different segments and the specific characteristics may vary from bond to bond, presenting always more complex structures. Differences may have to do with issuers, issue structures, geography, currency, maturity. Furthermore, the nature of the trading venues in which the bond can be negotiated affect the method of execution, the level of information available, market participants, market microstructures, liquidity dynamics. Pricing of bonds is obviously linked to the nature and structure of the financial instrument. For example, government bonds have a rate of return largely affected by macroeconomic trends and information widely available; evaluating corporate bonds might be more complex because of the credit risk factor which plays a central role for pricing them.

Such approach has been underlined in the IOSCO Report on “Transparency of Corporate bond Markets” (May 2004) where the need for a certain degree of transparency is confirmed. At the same time, regulatory authority are asked to assess the “appropriate” level of transparency in bond markets, taking into consideration a number of factors, including the size of the market, the frequency of trading of a particular bond or group of bonds, the participants in the market, the credit ratings of the issues, the trading methodology, the potential effects of any disclosure on liquidity, and whether the bonds are listed.

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

The Paper proposes a classification scheme for the purpose of the review which includes, as macro-areas, cash bonds, credit derivatives, asset-backed securities and other financial instruments.

CONSOB considers the proposed classification as a sufficient one for the review process.

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

The Paper identifies as possible rationales for transparency in fixed-income markets investor protection, market efficiency and cost considerations linked to the technology developments occurred.

CONSOB agrees on the rationales identified and would like to underline the following:

- ✓ It is certainly true that the growth of electronic trading provided an avenue for greater transparency to be provided to the markets. However, a large proportion of trading in bonds occurs outside electronic trading venues. *Such characteristic of fixed-income markets and costs related considerations should be taken into account but could not represent a limit to the introduction of a transparency regime where investor protection and market efficiency reasons require to proceed towards transparent markets on the basis of costs-benefits analysis;*
- ✓ It is certainly true that fixed-income markets are largely institutional but *the possibility for retail investors to access these markets, in one way or another, should be taken seriously into account when considering the investor protection side of the cost-benefit analysis* undertaken for the purpose of a transparency regime for bonds.

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

The Paper proposes to focus efforts “in decreasing intensity” on cash-government bonds, cash investment-grade corporate bonds, cash high-yield corporate bonds, asset-backed securities, credit default swaps and interest rate swaps and bond futures, and other financial instruments to the extent respondents consider there might be problem needed to be addressed. Such prioritisation of work is motivated by the prominence of investor protection concerns.

CONSOB believes that:

- ✓ *any prioritisation policy should take into account the nature of the financial instrument involved, the possibility for retail investors to participate the market and the role of transparency in making information available to all type of investors.* In case the wording “decreasing intensity” refers to a lower level of transparency, we believe that the proposed prioritisation does not reflect the right level of investor protection needed as in the case of credit derivatives;

- ✓ the development of credit derivatives markets had increased firms' ability to hedge positions and hereby manage the risks associated with market making. These markets are still young and more experience is needed before valuing their impact on trading in the cash market. However, *credit derivatives markets have gained importance and represent a crucial factor affecting pricing and trading of bonds in the cash market*. Regulation in this area might prove to be difficult and complex to develop but the relevance and risks posed by credit derivatives market should not be underestimated;
- ✓ MiFID stringent suitability requirements and effective implementation of best execution obligations imposed on retail brokers plays a central role in the protection of investor rationale. *Improved dissemination of price information helps brokers fulfilling their obligations and empower retail investors to monitor the quality of execution received from their brokers*.

In other words, *prioritisation is needed to schedule the work undertaken and the acquisition of information from interested parties and regulators in order to understand the different characteristics of financial instruments, the markets on which they are traded and the nature of investors involved*. It might prove to be very difficult to acquire a complete set of information, given the well-known OTC nature of the market (i.e. not listed bonds traded bilaterally outside regulated markets). In any event, *only after a fact-finding exercise giving a picture as complete as possible, a prioritisation policy can be developed on the basis of the investor protection rationale*.

- Q5 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 instruments markets under review?**
 - (b) **Evidence that mandatory pre and post-trade transparency would solve any of those problems?**

Please refer to answer to Q4.

- Q6 To what extent could recent and upcoming technological and market developments in relation to the instruments markets under review:**
- (a) **contribute to a relatively inexpensive extension of mandatory transparency?**
 - (b) **render mandatory transparency unnecessary?**

Please refer to answer to Q3.

- 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?**

Structural differences between equities and bonds are critical in the analysis of price transparency. Major differences are commonly identified in:

- ✓ liquidity of bonds is concentrated mainly in the period immediately after the issue and afterwards when specific information on the issuer or the issuance is disclosed

- to the market; furthermore, part of secondary liquidity is also going to be transferred market in credit derivatives and repos;
- ✓ trading frequency for bonds instruments is lower than for shares; day trading of bonds is rare unlike the share market;
 - ✓ although some valuable differences among EU jurisdictions still remain, amounts traded are often large and markets are characterised by the role played by dealers/market makers;
 - ✓ bonds are characterised by more complex structures which makes pricing more difficult;
 - ✓ price of bonds embodies additional and different information from shares; for this reason, price formation in bond markets has higher scientific bases than what can be observed for shares;
 - ✓ bonds shows less price volatility than shares

The above statements fit current situations of bond markets in European jurisdictions. However, ***CONSOB believes that a transparency regime should not be seen as necessary only on the basis of comparable conditions between bonds and equities. In other words, what really matters is whether there is a trading activity on a bond, whether retail investors are involved, whether supply and demand have a role in bond pricing.*** The fact that trading frequency is higher for shares, bond markets are mainly institutional or bond pricing is made up of additional and different information should not represent the basis for not having any transparency. It should be seen as a need to understand how bond markets work in order to define the transparency regime that better fits their characteristics.

Finally, ***the above statements are affected by market structures and regulatory framework in place in the various jurisdictions.*** In Italy, bonds are traded on 2 retail regulated markets (Borsa Italiana SpA and TLX SpA), 1 wholesale regulated market (MTS SpA), 2 multilateral ATSS (TLX and Bondvision, the latter operated by MTS Spa) and a number of bilateral ATSS. All the trading venues mentioned benefit a pre and post-trade transparency regime for transactions carried out on listed bonds, which is differentiated on the basis of the type of trading venue and participants (wholesale vs retail) and type of bonds traded. A certain degree of transparency is also available for unlisted bonds traded on ATSS. The regulatory framework and the transparency regime in place have proved to work well and, on the basis of the information available, did not have a negative impact on liquidity and investments strategies. ***The success of the MTS wholesale regulated market demonstrate how a dealer market do not suffer from a high level of transparency*** (data, on cash and repo, give the first five levels of the order-book depth in real time and the last traded price is shown).

Q8 What data sources do you consider relevant to the issues you have raised (if appropriate, cross-refer to you answers below)? Would you or your organisation be prepared to produce any relevant data if necessary?

CONSOB is currently involved in CESR works to provide expert and focused advice on factual and regulatory questions.

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

None.

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

Despite the key role of bond markets, there has been less academic and empirical attention assigned to bond markets than to equity ones. One of the main reason is the little information and datasets available to work on them, due to the lack of transparency of trading information.

Most of the academic works available refer to equity markets and even in this case the empirical results are somewhat ambiguous and do not allow any definitive conclusions. For example, in areas such the link between transparency and liquidity, some studies emphasises the negative impact that a higher degree of transparency can have on the incentives for certain categories of investors to participate the market and hence on liquidity but some other works revealed that transparency can improve liquidity if customers have to search for the best quotes and that information should be considered a public good so that the optimal level of transparency might not emerge spontaneously. Even the empirical studies on equity markets show how changes in pre-trade transparency can have various effects in different markets and that changes in the post-trade transparency regime in the London Stock Exchange did not alter liquidity.

In any event, any conclusions on the impact of transparency on price efficiency and liquidity available for shares should be taken with extreme caution. Please also refer to response under question Q11.

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

Academic and institutional studies on transparency in the cash equities markets rely on hypothesis and provide for conclusions which appears to be very specific to shares markets, also considering the data sets at the basis of such analysis. Any conclusions on the impact of transparency on price efficiency and liquidity available for shares should be taken with extreme caution since fixed-income markets present significant differences from shares ones which imply the adoption of different hypothesis at the basis of the models used to make any analysis.

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?

There has been some debate about the impact of TRACE post-trade transparency regime for US corporate bonds. Some argued that TRACE has caused a narrowing of spreads and had not adversely affected liquidity provisions. Some others also noted that the introduction of TRACE had revealed that there was a large share of retail trades and confirmed that all participant types had in some way gained from the introduction of the new post-trade transparency regime. Particularly interesting in this respect has been the data collected by

TRACE, the trade reporting and dissemination system recently introduced by the National Association of Securities Dealers (NASD) in the United States. The data shows that, although representing less than 2% of total value, 65% of the trades in reportable corporate debt transactions are valued at less than \$100,000, the NASD benchmark value for retail trades. This data suggests that despite the perception that the corporate bond market is mainly an institutional market, retail investors in the United States are participating in greater numbers

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?

The Paper underlines 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.

CONSOB certainly agrees on the need of a EU-based approach and regulatory framework in this area. A pan-European vision of the bond market is necessary. There is no one single bond market in Europe: different markets are differentiated in terms of types of bonds, level of liquidity, trading media and types of participants but these markets extend beyond national boundaries. Although some features could prevail in certain jurisdictions and not in others, there are no justifications for a different regulatory approach linked to geographic fragmentation. *Any failure in reaching a common understanding of such markets and shared regulatory approach to transparency for them would produce different outcomes in the various European jurisdictions and would lead to the risk of regulatory arbitrage and race-to-the-bottom approach.*

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?

There have been some discussions recently of what was meant by market failure and the issue whether markets worked efficiently and fairly. It has been often argued that any market failure could arise as a result of lack of competition in the markets.

EU markets have been characterised by a high degree of competition but fixed-income markets remain opaque with little price information and different possibilities for different types of investors to have access to the information available. From an economic point of view it is evident that lower transparency observed in such markets can be due to the implementation costs of transparency: more informed investors have an incentive to maintain a sub-optimal level of transparency in order to gain from information asymmetry and negotiate at favourable conditions; on the other hand, less informed investors, such as retail ones, are concerned about the risks posed by the absence of transparency and, in any event, they find it difficult to represent an effective demand for transparency.

CONSOB believes that rather than focusing on markets failures higher attention should be paid on: (i) whether markets could work better; and (ii) what can be inferred from the observation of market trends. To this end, specific consideration should be given to the following:

- ✓ *where financial instruments are to be traded on multiple trading venues, a transparency regime is a precondition for the possibility for investors to compare prices and evaluate their trading opportunities.* Such a statement clearly fits retail investors needs more than professional investors ones. However, information on fixed-income markets are still incomplete and lacking with respect to many dynamics to be able to say if bond markets are mainly institutional because of retail investors are not interested in them or because of their opacity which makes it difficult and costly for them to participate. Transparency certainly represent a condition for retail investors to reach a better knowledge and comprehension of the market and their investment decisions, which in turn may generate externalities in terms of retail investors participation in such markets and therefore increased efficiency and liquidity;
- ✓ *fair, transparent and liquid markets represent goals irrespective of the financial instruments involved.* Even if some instruments present specific characteristics which require to be carefully considered, a certain harmonised level of transparency should be pursued due to the positive implications in terms of possibilities for every type of investors to valuate, in a correct and continuous way, their investment opportunities;
- ✓ *In most countries, institutional and/or sophisticated investors have been the predominant investors and the extent of retail participation in the corporate bond market varies among jurisdictions.* In many countries, particularly those with longer-established equity cultures, both shorter and longer-term retail investment has tended to focus heavily on shares. *However, in some countries, retail investment in the bond market has been increasing and may be higher than previously recognised.* Particularly interesting in this respect has been the data collected by TRACE (please refer to response under question 12), the trade reporting and dissemination system recently introduced by the National Association of Securities Dealers (NASD) in the United States. As noted by IOSCO¹, increased retail participation in the corporate bond market may reflect a greater investor interest in spreading risk. Easier access to the market and increased transparency due to new technology, including electronic systems and internet access, may also be factors in some countries. While there is no way of knowing with certainty how retail investor interest in bonds will develop, there is some speculation that the demographic shift towards an 'ageing' population in many economically developed countries will lead to increasing demand for more stable income streams. On the “supply-side,” a number of issuers actively target the retail market and there have been initiatives in some countries to make the primary market more readily accessible to retail investors.

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?

The Paper outline four main options which could be analysed:

- pre-trade transparency: the no-change option, the option relying on self-regulation, a mandatory MiFID-like system but without a systematic internalisation regime and a mandatory MiFID-like system;
- post-trade transparency: the no-change option, the option relying on self-regulation, a mandatory TRACE-like system where all transactions are reported with a minimal delay

¹ IOSCO Report on “*Transparency of corporate bond markets*” (May 2004).

and a mandatory MiFID-like system where volume information are reported but with flexible system of delays according to volume.

CONSOB considers the four options outlined above as the right ones to consider, and cannot see other options to be considered.

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 governments 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 instruments you consider relevant?**

CONSOB opposes a no-change option in relation to pre a post-trade transparency in respect to transactions in classes of financial instruments other than shares, but it believes that is too early to draft conclusions on the approach to transparency that better fits the nature and the characteristics of bond markets. The fact-finding exercise together with deeper analysis in the area of bond markets are needed before valuing any option available.