



Deutsche Börse Group

Deutsche Börse's Response
to
European Commission's
Call for Evidence

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

Frankfurt / Main, 15th September 2006

Executive Summary

Deutsche Börse Group welcomes the opportunity to respond to European Commission's Call for Evidence on pre- and post-trade transparency provisions of MiFID in relation to transactions in classes of financial instruments other than shares.

Deutsche Börse Group plays an active role in the current European derivatives and bonds business and is therefore strongly interested in the subjects discussed in the Commission's Call for Evidence.

Deutsche Börse AG and SWX Swiss Exchange jointly operate Eurex which is the world's largest futures and options exchange. Together with international trading houses, Eurex operates the electronic network (ECN) Eurex Bonds, an over-the-counter market for cash and basis trading in fixed income securities and treasury discount papers.

As an integral part of the Deutsche Börse Group, Clearstream offers settlement and custody services to more than 2,500 customers world-wide, covering over 150,000 domestic and internationally traded bonds and equities.

Together with nine Investment Banks, Deutsche Börse is a shareholder of the International Index Company Limited (IIC). IIC provides transparency for fixed income and credit derivative markets in form of indices and constituent prices for fixed income instruments as well as credit derivatives denominated in Euro, Sterling and US Dollar.

Deutsche Börse Group fully supports European Commission's ambition to create an integrated and harmonised EU financial market, since we are very much in favour of transparent and efficient markets. Eurex markets for derivatives and bonds already provide a high degree of transparency: e.g. pre-trade information like best bid and ask prices incl. quote or order size and post-trade information, e.g. traded prices and volumes. This information level is already delivered by Eurex markets even outside the Community to the interested public.

Nevertheless, for the time being, we would recommend to abstain from a mandatory extension of the MiFID transparency regime to financial instruments other than shares for the following reasons:

- § The timing of this additional initiative to cover bond and derivatives markets before even empirical data and market feedback for the equity market is available is delicate. We would recommend first to gain some experience of step 1 before setting up rules to implement step 2.
- § Equity markets on one hand and bond or derivatives markets on the other are different markets in structure. Therefore, provisions intended to be applied in the equity markets should be carefully examined before being applied to bond or derivatives markets as well.
- § Bond and derivative markets are basically focused on wholesale trading. One should be careful to increase transparency in the wholesale (round lot) segment in order to make trading in the retail (odd lot) segment more transparent.
- § Having regard to the bond market, our view is that while a degree of transparency

(both pre- and post-trade) might be desirable to increase market efficiency and to enhance the confidence of investors, it could also significantly damage international competitiveness in what is a global and essentially wholesale market. The unintended consequence of implementing this proposal for the highly efficient and competitive Eurobond market could be moving it off-shore, out of the Eurozone.

Therefore, we believe that the case cannot be made for either position - full transparency or no transparency - and would suggest the Commission to wait until there is empirical evidence from the functioning of pre- and post-trade transparency in equity markets before looking at further legislative options. In any case, this analysis should take into account the difference in market and customer structure and the need for the EU to remain competitive internationally.

Please find below our detailed remarks to the questions raised by the Call for Evidence.

Detailed Remarks

Section 1 "Introduction" and Section 2 "Background"

We are fully aware of Art.65 (1) MiFID which requires the Commission to publish a report until 31st October 2007 and explicitly welcome the initiation of consultation with market participants at this early stage.

However, we are doubtful that, in the context of a better regulation agenda, the timing of Art. 65 (1) MiFID is prudently chosen, since the MiFID transparency regime for equity markets will be applicable until 1st November 2007 and there will be no related experiences when the report is due to be published. Building consultations about the extension of MiFID transparency regime to financial instruments other than shares is simply premature at this stage.

We recommend dealing with potential extensions of the MiFID scope very carefully in the sense of granting more time to the market participants to cope with already imposed multitude of rules. The rationale for this approach might be the sense of overloading and difficulty of timely compliance with the existing rule set among many market participants.

Before imposing new rules, there should be evidence first on the existence of a market failure and secondly that detected inefficiencies can sufficiently be solved by the legislator. Taking into account diverging views in the market and in the literature on the necessity of bond market transparency, this might be hard to prove.

Deutsche Börse Group believes that the MiFID rule set serves as a reasonable and workable regulatory framework for the EU financial markets so far, but we are also aware that there are critical voices in the market which complain about an extensively detailed rule set.¹ In order not to jeopardise the confidence of market participants and investors in a successful integration of EU capital markets, the Commission should consider very carefully the immediate necessity for additional rules.

An extension of MiFID scope prior entry into force of the origin rule set is difficult to justify. Thus, a possible outcome of the report could also be to postpone a decision on the extension of the MiFID transparency regime until there is empirical evidence on the impact of transparency requirements on the equity market and also on a positive impact of its extension on financial instruments other than shares.

¹ E.g. ECMI Policy Brief May 2006, "The MiFID Implementing Measures: Excessive detail or level playing field?".

Section 3 – Proposed Project Design

Question 1 (page 3):

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

We agree with the proposed scope of the report. We share the opinion of the European Commission concerning Article 65, which in the case of extension of transparency rules neither requires that the regulatory regime applying to equity markets is adopted one-for-one to markets in financial instruments other than shares, nor does it prohibit a differentiation of applicability to distinct asset classes.

Question 2 (page 4):

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

We would suggest the inclusion of European covered bonds, incl. German Pfandbriefe from the perspective of the German market, as an additional instrument class, since those are based on a specific legal framework and should be sorted between government and investment-grade bonds.

Question 3 (page 5):

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

Policy rationales should be inline with the guidelines already given by MiFID including investor protection, market efficiency and fair competition (introduction of a level-playing field). "Response to technological developments" might be a logical consequence out of these goals, but should not be mentioned as a policy rationale itself.

Beside investor protection as one of the main focus points of the rationale for higher transparency, counterparty protection should be added as well in order to discuss and find a balance between different investor groups (for details please see question 6).

Equally one should be looking at factors speaking against a possible extension. Here the question of international competitiveness and the risk of shift of bond trading outside the EU have to be taken into account.

Question 4 (page 6):

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

Covered bonds should be included as explained in question 2.

Section 4 – Discussion

4.1. Problem identification

Question 5 (page 7):

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?

Beside electronic trading platforms already delivering pre- and post trade price and volume information to the public, voice broker-supported as well as bilateral trades in the wholesale market segment are currently not published, i.e. information about prices and trades are just transparent for the involved counterparties. Electronic platform volumes therefore deliver transparency only for a limited share of the market because large volume tickets (block trades) are normally executed non-electronically. Electronic market share in the government bond market is much higher compared to corporate bonds, i.e. transparency in the corporate bond market segment is definitely lower.

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

There is no common understanding on the effect that increased transparency might have, since it could either lead to an increase or a decrease in liquidity. There are arguments in favour of increased transparency due to improvement in liquidity of the relevant market. The idea is that increased transparency improves information dissemination and encourages more participation on the buy-side. But transparency requirements could also lead to the opposite if dealers withdraw from market making through pushing up the compliance costs of transparency provisions.

Especially, the introduction of pre-trade transparency may lead to adverse effects in the market, as liquidity supply might be endangered. Taking positions results in taking capital risk, and if those positions are exposed to the market as it would be required by pre-trade transparency, capital could be withdrawn or moved to off-shore markets, in order to avoid an increased exposure to risks.

When managing the inventory, a liquidity supplier usually resells fractions of the purchased portfolio. If now information is available about the initial trade, the trader is put into a disadvantageous position, since other traders have incentives to behave opportunistically, knowing that the former is in need of liquidity.

The price formation process could be facilitated through increased transparency. But here, a distinction between liquid and illiquid markets should be drawn. If the relevant financial instrument is fairly liquid, the quality of its market pricing is likely to be high. Less liquid instruments might experience a better price formation process with increasing degree of price transparency.

However, it is not impossible that increased transparency and associated unclear impact on liquidity of the relevant market could result in a risk mark-up on top of the price to be paid by the end investor, since the dealer could pass on the increase in the risk of exposure of open positions to the customer.

Question 6 (page 7):

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?

and

b.) render mandatory transparency unnecessary?

With the introduction of electronic market places transparency already increased in Germany. Government bond trading is much more transparent than corporate bond trading, because a) the electronic market share is already higher in Government bonds than in the corporate bond segment where most of the trades are still executed non-electronically and b) volume and liquidity performance of the primary dealers in the secondary market is regularly monitored by issuers setting up specific rules for Market making in the secondary markets to become (or stay) a member in the Primary dealer group.

Already now, there are multiple electronic wholesale trading platforms providing the public with transparency data complemented by exchange prices of bonds for retail investors. Indeed, it remains questionable, if mandatory transparency for the bond markets really will support or hinder liquidity.

Note: Similar requirements would have to apply to deals performed bilaterally and in the voice-brokered OTC market. If not the case, this might lead to a back-shift from electronic sources to bilateral trading, and as the result the initiative sees less transparency than before. But the voice-brokered market even for block trades exists quite successfully beside electronic trading platforms because of trust, confidence and relationship all protecting the counterparties. Full transparency again damages this relationship and makes it harder to execute block tickets.

On the other hand, a theoretic optimum of transparency with pre-trade information of all bid-offer prices, the related size and also the identities delivering these prices might damage market quality, i.e. the execution of block trades would be very hard to achieve without moving the market because everybody would be informed about player's intention in advance.

Total volume and liquidity transparency (even about pre-arranged business) is not in the intention of the counterparties being involved in a specific trade even with regard to block trades → *counterparty protection*.

A forced increase in transparency could potentially lead to a decrease of liquidity, i.e. lower quote and trade sizes, because Market Maker would face a higher "execution risk" (the general risk a market maker is taking by continuously delivering liquidity) if markets are more transparent, therefore they could reduce their individual quote size to act more cautiously.

There is already the trend of declining volumes in the cash bond market and a shift towards exchange-traded futures also explaining the huge increase in turnover and open interest in the Bund-, Bobl- and Schatz-Future at Eurex over the last twelve months because of deep order book volume with easy and anonymous execution of larger tickets.

Question 7 (page 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?

The most important difference between equity and bond markets lies in the market microstructure and the inherent price discovery mechanism. The quantity of issued bonds is by far larger than equities. Bonds usually have a defined maturity. Trading sizes and liquidity are much higher compared to equities. Much more a wholesale market, retail orders usually go to exchanges with specific auction mechanisms. Therefore, hardly any transaction occurs on exchanges in the wholesale or institutional market, while the main trading activity takes place in the retail segment. At the same time, exchanges use their opportunities to position themselves in the OTC market which most likely will enforce the trend to more increased competition in the bond market.

For equity markets it is indeed true that a low degree of transparency can lead to information asymmetries, which in turn makes it hard to prove whether the price prevailing in the market is efficient. But this phenomenon is less prominent in bond markets, where private information about a company's operations are less important for investor's decision, since return on investments from bonds are less depending on firm-specific characteristics, but more on macroeconomic conditions, e.g. interest rate changes and related expectations about monetary policy, indebtedness of a country (if government bonds), etc.

In contrast to the equity markets, especially the bond market is mainly a global market. If market participants feel overburdened by regulation in the EU, they will be able to move their business to offshore markets with more liberal rules. The shift of the Eurobond markets since the 1960's is proof of this.

Question 8 (page 7):

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?

Eurex and Eurex Bonds already deliver an adequate level of pre- and post trade transparency for derivatives as well as fixed income instruments traded on their markets.

Eurex, e.g. provides best bid / best ask including volumes as well a market depth for the most liquid futures down to the level of 10, as well as all Trades (price and volumes).

Eurex Bonds currently disseminates best bid / best ask as well as traded prices and volumes. All data is disseminated including time stamps, high and low of the day, as well as further additional value add information.

All of this information is delivered via Deutsche Börse's Market Data & Analytics department to information vendors and interested members and non-members directly and via information vendors to the interested public.

Via IIC further transparency for fixed income as well as credit derivatives instruments is made available to the public. IIC compiles data from leading banks and information providers and makes it publicly available. The multiple contributor concept ensures that data is objective, fair and independent. Users of the data can get a true view by referring to the relevant iBoxx or iTraxx prices and indices. On behalf of IIC Deutsche Börse's Market Data & Analytics department calculates and makes available the European Fixed Income Indices and constituent prices to market data vendors and thereby to the public.

4.2. Relevant academic and institutional work

Question 9 (page 7):

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

European Commission has indeed conducted a very detailed research on the relevant and helpful publications.

We recommend the inclusion of the following literature:

- Biais, Glosten, Spatt, "The Microstructure of Stock Markets", CEPR, 2002, since it examines whether greater transparency enables market participants to protect themselves against more informed ones depending on the degree of importance of private information in the relevant market. Here, the importance lies in the difference between equity and bonds markets and implied transparency requirements due to the specific microstructure of the equity market.

- Lawrence Harris, Michael Piwowar, "Municipal Bond Liquidity", American Finance Association, 2005, since it examines possible benefits of increased transparency for retail investors in particular.

Question 10 (page 7):

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

There seems to be a balanced relationship of transparency and liquidity, but in our opinion, no case can be made to date for either position – full transparency or no transparency.

As the diversity of opinions on the topic is large, so academic results are manifold too. Depending what is in the focus of analysis (liquidity, market efficiency or investor protection), results are often ambiguous. There are two main streams concerning the degree of transparency in the bond markets.

1.) Full transparency in the bond markets is favoured:

Increase in market transparency lowers customer transactions costs and hence encourages a higher degree of market participation. The benefit is mostly pronounced for retail investors. Competitive forces resulting from increased transparency would result in reduction of effective spreads, which is equivalent to an increase in market efficiency.

However, there is no clear evidence that the overall effect in terms of improved economic welfare resulting from increased transparency is positive. As FSA in its Discussion Paper on the issue states, there are concerns about the methodology used to be taken into account. The authors have used statistical estimation methodologies, but no quotation data existed for most of the corporate bonds, so studies cannot rely on standard transaction methods like effective spreads based on benchmark prices. In addition, bonds trade infrequently, so that sample size could be limited or biased. On this basis, the authors could not show that the overall effect of increased transparency is positive.

2.) No pre-trade transparency in the bond markets is recommended:

Increased pre-trade transparency might lead to reduction of the liquidity on the sell-side of the market. Too restrictive transparency requirements imply high compliance costs for dealers, who as a response might withdraw from market making.

Increased transparency imposes the risk of a top-down market structure associated with overregulation for a market which is already highly efficient. This could impede market innovation and flexibility.

Question 11 (page 7):

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

Bonds are different from equities (question 7). The block trade issue of equities nevertheless seems to show parallels to block trades in the wholesale bond market.

Question 12 (page 8):

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?

In contrast to the US, the European bond market is dominated by government bonds, whereby the market share of corporate bond issues is relatively small.

However, the types of instruments are similar. Despite a single currency, differences exist in Europe regarding heterogeneous national legal and tax regimes, different interest calculation and day count methods, domestic regulatory frameworks, etc. On top of that, cash bond volume compared to volumes in fixed income futures in Europe is much smaller, FI futures have benchmark character rather than the on-the-run cash government bond (i.e. the most recent issues in the different maturity buckets) as in the US. Electronic trading in Europe is split up between a variety of platform providers (according to BMA 2004, more than 40 platforms in Europe) offering multi-dealer B2B and B2C solutions as well as single-dealer to client offerings and hybrid models supporting voice brokerage firms.

4.3. Additional filters in problem identification

Question 13 (page 8):

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 on this insofar member states do not have pre-existing regulation in the transparency field. It should be kept in mind that we are talking about a European market (despite the differences as described above in comments to question 12) and that all future regulatory changes should apply throughout the EU.

Question 14 (page 8):

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?

An increase in electronic market share even in the corporate bond segment would naturally lead to an increase in transparency in this segment. There are manifold offers of open order book trading services for the bond and derivative markets which offer market participants to choose the degree of transparency wished for. Thus the market can choose whether to evolve in the direction of more transparency without intervention of the legislator.

Usually, the derivative activity is driven by the fast exposure to the underlying asset. Especially in the OTC derivative market counterparty risk is involved, which makes this market accessible only to market participants who exhibit an excellent credit rating. Those are mostly big institutional investors with a need for individualized, tailor-made products which are impossible to be offered in a standardised platform trading environment.

The investors will therefore value their personal relationship with dealers in the OTC environment due to their preference for discretion.

In addition, the microstructure of the OTC derivative market is particular in the sense that the same agents are designing the security and providing liquidity for it, namely the dealers themselves.

Section 5 – Options for Discussion

Question 15 (page 9):

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 agree with the four options proposed.

Question 16 (page 9):

Would you, in light of your answer 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?

We would recommend the inclusion of covered bonds into the examination. But, as already highlighted above, we do not recommend the extension of the scope of MiFID rules to any of these instruments for the time being.

In the light of the arguments mentioned above, we would, if the Commission came to the conclusion that it needed to act after all, generally prefer mandatory MiFID-like systems but with flexible rules of delays according to volumes, if the following pre-requisites are fulfilled:

- market can absorb the rules: for us, it is a matter of concern whether the market is able to cope with additional regulation, while still not being fully familiar with existing MiFID regulation
- existing market failure: evidence about whether there is a market failure should be provided in advance, before setting up a regulatory approach
- evidence that market failure, if it is given, is solved by enhanced transparency for each financial instrument listed above.

Otherwise we would prefer, taking into account the first two options, bearing in mind that at this early stage (before original MiFID rules are applicable) a solution could be no-change in first instance and a possible re-opening of discussion when sufficient and reliable information on the impact of MiFID transparency rules on equity markets exists.