



FINAL RESPONSE

DG Internal Market: Call for Evidence on transparency in bond markets and other non-equity markets

1. The European Banking Federation (FBE)¹ welcomes the opportunity to comment on DG Internal Market's call for evidence on transparency in bond and other non-equity markets.²
2. The Commission's Call for Evidence in respect of transparency in non-equity markets comes at a time when banks are in the midst of delivering against detailed plans to implement MiFID by the November 2007 deadline. With MiFID systems untested and business models still uncertain, the remarks the banking community can offer at this stage, by their very nature, have to be considered as preliminary.

I. General remarks

3. Whilst we appreciate that the Commission is obliged to report in accordance with Article 65 of the MiFID Level 1 Directive according to a pre-defined timetable, we highlight nonetheless that at this time it is **practically very difficult to predict how the implementation of MiFID would have a bearing on transparency in the non-equity markets**. Even though MiFID does not contain transparency provisions for non-equity markets, transparency could well evolve notwithstanding legislative intervention in this area.
4. The FBE calls on the Commission to take this into account and where at all possible **consider postponing any judgement and subsequent policy decisions in respect of transparency in the non-equity markets** until the financial industry and regulatory authorities could make a fair assessment of the effectiveness of systems and the opportunities MiFID is designed to deliver. This we feel would be in line with the Commission's own recommendations in respect of better regulation and allowing for a regulatory pause.³
5. Importantly, we firmly believe that there is not sufficient evidence available today that point to the non-equity market exposing investors to excessive or unforeseen risk. On the contrary, today's European non-equity markets offer choice to investors, thanks to healthy levels of competition, whilst product innovation continues and market structures mature. Therefore **we do not foresee a market failure in the non-equity markets** to address at this present time.
6. We note that the Commission presents the potentially positive impact of mandatory market transparency without equal regard to the potential downsides. As the debate on the application of MiFID transparency provisions to non-equity products matures, market participants have articulated a collective scepticism towards applying pre-trade transparency requirements to non-equity and a number of

¹ The European Banking Federation (FBE) is the voice of the European banking sector representing the vast majority of investment business carried out in Europe. It represents the interests of over 5,000 European banks, large and small, from 29 national banking associations, with assets of more than €20,000 billion and over 2.3 million employees.

² The views expressed in this response do not reflect those of the Italian Banking Association (ABI).

³ See European Commission's Green and White Papers on Financial Services Policy 2005-2010.

reservations in respect of post-trade transparency for the same asset classes.⁴ The Commission's focus and prioritisation should, therefore, also **consider the arguments against mandatory MiFID transparency for non-equity products** as well as the potential positive impacts.

7. In any event, the **burden of proof rests on the Commission** to demonstrate where market failures lie and why a particular course of action would be optimal for Europe's Single Market. A general presumption that market failures exist would not be not sufficient. Market failure must be proven for every single market before considering public policy intervention. Since public policy intervention will distort the market to a certain extent, proving the existence of market failure is only a first step. The Commission must also demonstrate that the market is incapable of reaching optimal transparency by market-led activities over an adequate period of time. A thorough cost benefit analysis would also have to underpin the analysis carried out by the Commission.
8. We consider that the exercise of gathering evidence on non-equity market transparency could nonetheless be useful at this stage from a **wider Single Market perspective**. Recital 46 of the MiFID Level 1 Directive allows for Member States to decide to apply pre- and post-trade transparency requirements laid down in the Directive to financial instruments other than shares. Whilst Recital 46 has the possibility to disturb the level playing field in the Single Market, we nonetheless recognise that certain market specificities can render such a provision necessary.
9. However, we urge the Commission to scrutinise carefully, arrangements admitted under Recital 46 against the criteria set out in Article 4 of the MiFID Level 2 Directive which deals with **additional requirements on investment firms in certain cases**. In the event that jurisdictions wish to apply pre- and/or post-trade transparency arrangements that fall outside the scope of MiFID, Member States must clearly demonstrate to the Commission the nature and extent to which their particular market structure could warrant additional requirements.
10. By way of summary of the FBE's position, we believe that due to the unique nature of the price formation process, liquidity, frequency of trading, sizes of trades, market structure, history and potential capacity for innovation in the future, the **Commission could not justifiably recommend policy intervention at this stage in respect of pre-trade transparency in the non-equity markets**. This opinion is confirmed by the fact that non-equity markets are generally working well as evidenced by few customer complaints, healthy levels of competition and encouraging level of innovation. Therefore, irrespective of the very real difficulties and costs of establishing a pre-trade transparency regime for non-equity would imply, we are not aware of any significant market failure pre-trade transparency could usefully address.
11. Post-trade transparency for non-equity markets exists in some Member States and appears to work well since markets have arrived at an appropriate delayed reporting regime for publishing data after the trade. The most appropriate delay typically varies from market to market and product to product. Importantly, the justification for post-trade transaction reporting varies, according to client base across markets. **Post-trade reporting may be possible in some markets but we remain to be convinced as regards the market failures mandatory post-trading rules would address**. We are similarly sceptical as regards the

³ See "Report on CESR's Wholesale Day", 1 June 2006; CEPR studies, May 2006, "European Corporate Bond Markets: transparency, liquidity and efficiency" pp.66-67 and "European Government Bond Markets: transparency, liquidity and efficiency" pp. 56-59.

cost/benefit rationale especially when taking into account the related start up and ongoing costs. The Commission should also take into account that mandatory price transparency has been shown to hinder the provision of liquidity and therefore is detrimental to market efficiency.

12. Finally, we understand that the foreseen **provision of investment advice under MiFID** will, to a large extent, alleviate potential information asymmetries between the seller and the buyer, broker and (retail) client, of non-equity products. If this is the case then it could be argued that the investor protection rationale argued by the Commission would already be addressed to a significant extent. Therefore, transparency that has to be made available directly to retail investors would only become a significant issue when they participate directly in execution-only in non-equity products. Here, we believe that the restriction surrounding the circumstances and conditions under which a retail client could undertake execution only business, is pertinent.

II. Answers to questions

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

13. The Commission is right to recommend that MiFID transparency provisions would be best applied *per class* or specific classes of non-equities. This approach correctly reflects the fact that non-equity markets are not homogenous in terms of structure, nature of the instrument or the investors who typically enter into the market. Therefore, it follows that a **single approach to the MiFID transparency requirements for non-equities is not appropriate**.
14. However, whilst the principle of differentiated transparency across class or specific classes of non-equity is conceptually sound, regard must be paid to the **associated costs and burdens** a tailored transparency regime for specific non-equity products could create. Therefore, the FBE recommends that the Commission assesses in detail the relative merits, costs *versus* benefits, of such a differentiated approach as proposed in the Call for Evidence.

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

15. The classification scheme would appear to be **sufficient for the purpose of the review**. We also believe that the level of granularity is broadly acceptable as proposed. However, a more granular categorisation could stymie innovation in what is a rapidly evolving market, by restricting conceptual and practical flexibility.

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

16. At the centre of the Commission's consideration of how far, if at all, ought MiFID transparency requirements to be extended to (some) non-equity products, must be the trade-off between protecting investors and creating a policy framework to allow for efficient markets, especially taking into account the negative consequences of mandatory transparency on the incentives to supply liquidity. The FBE does not insist that transparency is automatically a boon for investor protection but a hindrance to market efficiency, rather the fundamental issue centres on achieving the **optimal level of market transparency** that adds demonstrable value for investors and markets alike. Therefore, the Commission would be right to consider

investor protection alongside market efficiency as being equally important policy rationales for mandatory transparency.

17. We also welcome consideration being given to **technological developments**. Nevertheless, we urge the Commission to be led by considering where market failures have been demonstrated before considering technological feasibility. Clearly, technological developments are a means to an end, but should not by themselves be the main driver of policy decisions.
18. Finally, as reflected in our general remarks and in line with the Commission's welcome commitment to evidence-based policy making, we would fully expect the **burden of proof to be upon the Commission**, and not the industry, as could be suggested by the Call for Evidence. In other words, the Commission is responsible for demonstrating where market failures occur, and then, in consultation with stakeholders, assessing the relative merits of a number of approaches to address identified market failures.

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

19. Firstly, we **strongly support there being a prioritisation in the review** as not all class of non-equity products or their markets are characteristically uniform, nor is retail investors' exposure to those products or markets.
20. It is also right to follow the principle that **policy should be driven by where potential investor protection concerns are most prominent**. This approach assumes to a certain extent that there is a sufficiently significant risk to investors from the present arrangements foreseen under MiFID, where market transparency is limited to equity products. In line with this principle, we would expect the Commission's intentions to be informed by empirical data that it is encouraged to present in its formal consultation on this issue regarding the exposure and the projected exposure over time of retail investors to non-equity products, as compared with wholesale participation in non-equity markets.
21. The Commission fails to mention the **market efficiency policy rationale** in its prioritisation of the review. Representing participants in the market, this area is of crucial importance to the FBE and should be a more prominent consideration in the Commission's prioritisation. Since the Commission does not mention the market efficiency policy rationale as a driver of the way in which it intends to prioritise its review, it could be concluded that there is an implicit recognition that non-equity markets currently work well and would not necessarily benefit from greater transparency obligations. If this is indeed the case, this opinion ought to be clearly stated by the Commission in further consultations on this issue with stakeholders.

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

- a. observable or demonstrable problems, with respect to the possible policy rationales for mandatory transparency identified above, in relation to one or more of the instrument markets under review?
- b. evidence that mandatory pre- or post-trade transparency would solve any of those problems?

22. Firstly, we welcome the Commission's regard to evidence-based policy making as set out in its approach to problem identification.

23. Asymmetries of information in respect of price formation in the non-equity markets do not represent a market failure *per se* but rather a necessary characteristic of this particular market. Obtaining the right amount of information is part of the market process. At the same time, this information asymmetry is the main driver for market participants to supply liquidity to the market.
24. The FBE believes that the non-equity markets, especially those markets where the Commission intends to scrutinise in greatest depth, generally work efficiently and in a manner that has evolved over time to suit best, the nature of the instrument and the relatively (compared with cash equities) low levels of liquidity in the markets. **Non-equity markets are generally considered to be efficient**, since users can make explicit preferences within the market, there is healthy competition and the markets are evolving. This statement also implies that the levels of opacity in the non-equity markets do not necessarily hinder the price formation process but are in fact a necessary feature of a market where primary dealers need cover to risk capital and take positions.
25. The question that the Commission must answer is therefore, **how far can pre- and post-trade transparency eliminate market inefficiencies** (if they can be proven to exist) and enable all classes of investor, including retail investors, to enter into the non-equity markets with an appropriate degree of protection.
26. Firstly, **pre-trade transparency should be decoupled from post-trade transparency** for the purposes of the Commission's review. Although related by objective, in terms of practical application to today's generally well functioning non-equity markets, pre-trade transparency would be significantly more difficult to apply than post-trade transparency. That is not to say that the application of post-trade transparency would be straightforward, or necessarily beneficial to protecting investors for some asset classes.
27. Secondly, in terms of the Commission's policy rationales, mandatory pre- and post-trade transparency could, in terms of investor protection alleviate information asymmetries, enable (retail) investors to verify if they have received best execution, and aid periodic fund evaluation. However, this could come at a significant **cost to (wholesale) market efficiency**, to the extent that liquidity could be driven from the market which would clearly be contrary to all investors' interests in the long run. At the same time, an alleviation of information asymmetries takes away the incentive for market participants to gather information because there is no competitive advantage to be gained. The overall market information might therefore decline, and with it, market quality.

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

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

28. Europe's non-equity markets are maturing and have tailored their transparency requirements to the market need. The banking community would argue that the non-equity markets must mature in an organic manner and public policy makers have a responsibility to ensure that the (legislative and/or competitive) conditions are ripe to allow for such market developments to occur. Therefore, it is **too early to tell how far market developments will make it theoretically possible, if not easier, to have a relatively inexpensive extension of mandatory transparency**, or indeed to render mandatory transparency unnecessary.

29. Likewise, industry is currently faced with the significant prospect of implementing the technological systems to be compliant with MiFID by November 2007. At this stage it is also too early to tell how far technological ‘add-ons’ would render the extension of MiFID pre- and post-trade transparency relatively straightforward and inexpensive. **Time is needed to ensure the efficient operation of MiFID systems before any extension could be considered.** It must be noted that while equity markets are mostly electronic, non-equity markets due to their more bespoke nature are characteristically OTC (with trades carried out over the phone) so the costs incurred for transparency provisions would be on a much higher scale.

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?

30. Non-equity financial instruments differ from cash equities in a number of significant ways, all of which point to justifiably lower levels of mandatory transparency. Three major differences are in terms of:

	<i>Cash equities</i>	<i>Non-equity instruments</i>
Liquidity	Relatively liquid	Relatively illiquid
Volume size	Relatively small	Relatively large
Frequency of trade	Relatively frequent	Relatively infrequent

31. Cash equities better lend themselves to being traded electronically and in a more transparent manner. Since transparency naturally follows liquidity in the market, mandatory pre- and post-trade transparency, although it could hinder the price formation process in less liquid stocks by driving away liquidity, should be relatively easier to apply than for the non-equity markets. Where stocks are relatively illiquid, and are traded in large block sizes relatively infrequently, primary dealers take on greater risk. Exposing those positions *prior* to a trade, puts the primary dealer at an even greater risk and ultimately leads to there being a strong disincentive to enter the market at greater cost, or, at all.
32. Public policy should be in line with the characteristics of the market therefore, and great **caution is urged when considering mandatory transparency in markets, which rely on primary dealers and OTC or bespoke transactions.**
33. Crucially, the Commission is encouraged to recognise that an **absence of mandatory transparency does not imply an absence of transparency per se in the markets.** Achieving optimal transparency, which allows markets to function efficiently while appropriately providing some of the tools necessary to protect investors, ought to be the common aim. The decision on how to work towards optimal transparency should therefore recognise that there is already a “close to optimal” transparency in non-equity markets as evidenced by a very limited number of market failures, healthy competition and a general absence of complaints from retail customers. Market forces and competition between different transparency regimes are the best guardians of the needs of participants who are best placed to advise regarding market innovation and development.

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

34. The data sources listed by the Commission and the CEPR studies reflect the corpus of information on this subject that is currently available and in the public domain.

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

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

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

35. We underline the need for the Commission to call on **market experts to supplement the conclusions that can be drawn from the relevant academic literature**. The FBE remains at the Commission's disposal to provide such expertise, should the Commission welcome the views of bond, and other non-equity market experts, in the evidence gathering stage.

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

36. The most important conclusions as regards possibly applying a TRACE-like system in Europe can be drawn from the relevant CEPR research.

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?

37. In line with our general conclusion, the **FBE does not believe that EU level intervention would be warranted** at this stage.

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?

38. The non-equity market has shown dynamism and a capacity for innovation in the past and with enabling legislative conditions in place it will continue to develop in the future. We firmly believe that **as the non-equity markets evolve then transparency will adapt accordingly**.

39. Ultimately, the market itself acts as an incentive to efficiency and fair competition between market participants, and as an incentive to growth, development, and innovation. Therefore, whilst inefficiencies are evident in any market, **operational inefficiencies will in all likelihood be addressed at the appropriate time by the markets themselves**, since there is a strong incentive to do so.

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

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

[...]

40. In respect of the options presented, **the FBE does not comment, since it does not accept the premise that now is the right time to consider extending MiFID or introducing a MiFID-like pre- and post-trade transparency regime** for non-equity markets. In any event, for the reasons highlighted above, we advocate caution in comparing the equity and non-equity markets and consequently seeking to analyse experience from one market to apply to the other.