



**CALL FOR EVIDENCE BY THE EUROPEAN
COMMISSION**

**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**

A response by the Futures and Options Association

September 2006

Extending the Transparency Provisions in MiFID to Transactions in Financial Instruments other than shares

1. Introduction

- 1.1 The Futures and Options Association (FOA) is the industry association for some 170 firms and institutions which engage in the carrying on of derivatives business, particularly in relation to exchange-traded transactions, and whose membership includes banks, brokerage houses and other financial institutions, commodity trade houses, power and energy companies, exchanges and clearing houses, fund managers and firms involved in supplying services into the futures and options sector.
- 1.2 The FOA recognises that the Commission is mandated to report to the Council of Ministers and the European Parliament by the end of October 2007 on whether – and to what extent – the new EU requirements on pre- and post-trade equity transparency should be introduced to trading in other financial instruments shall as bonds and other non-equities. In this context, the FOA welcomes particularly the statement by Charlie McCreevy, Commissioner Internal Markets and Services that *“MiFID requires us to investigate whether it would be appropriate to impose any pre- and post-trade transparency provisions on markets in financial instruments other than shares. I have a completely open mind at this stage. These are massively important markets – so the Commission is carrying out scrupulous, fundamental research.”*
- 1.3 The FOA takes the view that increasing the regulatory burden on firms or introducing significant changes to market practice, particularly where they are going to increase the cost of execution (particularly for customers and other end-users of the markets) or changing market business models should not be undertaken, unless:
 - (a) there is identifiable market failure or failure in investor protection standards or there are significant and well-authenticated complaints regarding market practice which point to the need for improvement;
 - (b) the proposed changes are proportionate to addressing any such identified failure and CESR is satisfied that they are the best way of addressing any such failure;
 - (c) proper account is taken of the implications for the competitiveness of EU infrastructure providers and institutions e.g. by identifying and comparing the regulatory approach taken in other non-EU countries to the question of transparency in non-equity markets (particularly in those which have substantial non-equity markets);
 - (d) the changes proposed are justified on grounds of market impact and cost/benefit analysis and, in particular, the impact on such changes would undermine market participation and liquidity on EU exchanges and OTC markets and the potential for participation to migrate to markets outside the EU.

- 1.4 The FOA believes that these criteria are consistent with the Commission's better regulation agenda and the Lamfalussy Principles and they should govern the question of whether or not to extend the transparency requirements in the MiFID Directive to non-equity markets and dealings.

2. General Observations

- 2.1 In responding to the request for views, the FOA would make the following general observations:

- A significant distinction should be drawn:
 - (a) between the level of transparency that prevails in exchange-traded markets and OTC markets; and
 - (b) between the capital raising and investment functions of equity markets and the economic and risk management functions of other wholesale professional markets (which, in the case of commodity markets, are designed to meet the commercial, economic and risk management needs of producers, manufacturers, refiners and other entities engaged in commercial trade).
- There has been no apparent market failure attributable to a lack of transparency in derivative markets which, in the case of exchange-traded derivatives already exhibit a high-level of acceptable transparency and, in the case of OTC derivative markets (which are largely bilateral, professional markets), the current level of transparency is informed by market participant needs for dealing confidentiality and the tailored nature of many of the transactions undertaken in those markets.
- In the case of commodity derivative markets:
 - (a) the issue of transparency is, in large part, dependent upon the prevailing level of transparency which applies to the underlying asset, which, not being a class of regulated financial instrument, falls outside the remit of financial regulators (and, in the context of energy markets, is already the subject of investigation as part of a much wider ongoing Competition Directorate enquiry);
 - (b) transparency on the equity markets is driven in large part by the concept of issuers and the activity of systematic internalisation – both of which are unique to dealings in equities.

- 2.2 The FOA believes that the Commission should take into full account the role and influence on financial markets of competition, market evolution and, when it is exercised, buy-side pressure on price setting and their capacity to drive forward appropriate levels of market transparency – critically, on a market-by-market basis. As it was put by the FSA in its feedback statement FSO6/4 Trading Transparency in the UK Secondary Bond Markets:

- (a) *"Transparency is not an end in itself"* (para 1.4);

- (b) *“While the anecdotal, empirical and theoretical evidence does not provide absolutely clear conclusions, we do not see any evidence of substantial market failures related to transparency in wholesale bond markets based in the UK. We agree with the view of the majority of respondents that a combination of competition, market-driven transparency, the inter-action between cash and credit derivatives markets, and regulation seems sufficient, in general, to deliver efficient pricing and fair executions”* (para 1.7); and
- (c) *“Extreme caution would need to be exercised in mandating greater transparency in the UK and Europe. In particular, we agree with many respondents, and with the conclusions of the CEPR research that mandating pre-trade transparency is likely to impact on the existing complex market structures, in potentially significant but unknown ways. We also note that these markets are still relatively dynamic, and continuing to evolve”* (para 1.7).

3. Specific Comments

- 3.1 The FOA is appreciative of the opportunity of commenting in response to the Commission’s Call for Evidence and notes the welcome confirmation (para 2.2 in the Commission’s paper) that there will be a further public consultation once the Commission has prepared its Report and while it is still in draft form.
- 3.2 The FOA notes that the Commission’s report will extend to “transactions in all classes of financial instruments other than shares”, but has noted that it:
- will be guided by the identified policy rationales for mandatory transparency (para 3.3);
 - that it will not “examine every class of instrument with the same intensity” (para 3.3);
 - that, more particularly, will prioritise those markets “where potential investor protection concerns are more prominent” (para 3.3), which it also identifies as being “particularly relevant to markets such as cash government and investment-grade and high-yield corporate bond markets as well as asset-backed securities markets” and not therefore in other in other non-equity markets.
- 3.3 With regard to derivatives markets, the Commission’s view appears to be that they will investigate certain OTC markets because of their interface with cash bond markets, but the FOA would emphasise that, as they have decided, their focus will be on those markets “where potential investor protection concerns are more prominent”.

The FOA would argue therefore that, notwithstanding the identified linkage, where the Commission’s principal “investor protection” policy rationale does not apply to those related markets while the caveats expressed in para 2.2 above should prevail (subject to ongoing regulatory due diligence monitoring). The FOA would also express the view that, even where there are investor protection concerns, if they are not capable of being identified in terms of evidenced market failure, the rationale that they are potential or possible

future concerns would, in the view of the FOA, be insufficient justification for any form of market-changing actions.

- 3.4 The FOA also notes that, while the Commission will be investigating a broad spread of “other financial instrument markets”, this will be limited to the extent that respondents to this Call for Evidence consider that there are or may be problems that need to be addressed and that the list set out in 3.3 gives low priority to derivatives markets. The FOA very much supports that conclusion, but believes that, if any such requests are received, the nature of them and the category (not necessarily the identity) of the complainant should be identified as part of the open consultative process and to ensure that industry responses are properly informed and researched.

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

See paras 2.2 and 3.2 to 3.4 above.

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

The FOA questions the value of committing time and resource to reviewing markets and instruments which the Commission has already indicated are low priority and where its investigation would only apply where respondents consider “that there are or may be problems that need to be addressed”. On this basis, the FOA would urge the Commission to restrict its activities to priority markets and only include other markets where there are specific and authentic observations from respondents justifying an investigation (see also paras 3.2 to 3.4 above).

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

The FOA supports the identification of “investor protection” as a rationale that should be taken into account in deciding its priorities, but would emphasise that a strong distinction needs to be drawn between retail and wholesale markets/dealings and the risk that imposing a regulatory burden on international and professional markets which are not reflected elsewhere could exacerbate cost and undermine dealing confidentiality to the extent that market participants may look to engage in comparable dealings offshore to the EU.

The FOA would reiterate its concerns that the Commission seems to have included as the basis of this rationale the prospects of “potential” investor protection concerns. It would, in the view of the FOA, be a serious error of judgement if the EU’s inter-professional and international dealer markets were to be subject to any changes in the currently broadly accepted business model of those markets on the grounds only of “potential” investor protection concerns. Any such move would almost certainly fail even the most basic cost/benefit and/or market impact analysis.

In terms of “market efficiency”, the FOA recognises the importance of sustaining efficient markets, but would rephrase the question on the basis that specific market inefficiencies should first be identified, because increased mandatory transparency may not be the cure for any such identified inefficiencies – rather than making the assumption that they either will or are

likely to do so (which would contravene the view that “transparency is not an end in itself” (see para 2.2 above)).

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

The FOA reiterates its concern (relevant also to its response to Q3) that the Commission has demonstrated a clear bias towards looking for ways of justifying imposing transparency requirements on other than equity markets insofar as it is expressly not seeking policy rationales which would not justify the extension of mandatory transparency to such markets. This may be a drafting error, but it does appear to be the overall “flavour” of the Call for Evidence and this does not appear entirely consistent with the statement of the Commissioner that there is a “completely open mind” on this matter (see para 1.2 above).

The FOA notes the Commission’s priority on investor protection concerns, but would emphasise that mandating transparency because there are “potential” investor protection concerns is inconsistent with the demonstrable market failure test and, having identified investor protection as a prime consideration, the FOA is also concerned that, notwithstanding that they do not exist, the Commission is seeking to justify action in relation to derivatives markets because they are “intimately linked to the cash bond markets”. As the Commission will be aware, there is no retail participation in the markets identified by them. They are international, professional markets in which the mandating of transparency for transparency’s sake could achieve precisely the unintended consequences, including a major shift in market shape, which could lead to their migration offshore from the EU. For this reason, the FOA would emphasise the critical importance of any such action being fully justified by proven market failure on a reasonably significant scale.

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

See paras 3.2 to 3.4 above.

Q5: To what extent do you consider there to be observable or demonstrable problems, evidence that mandatory pre- or post-trade transparency would solve any such problems?

The FOA is of the view that, in relation to the markets relevant to it as a trade body, there have been no known observable or demonstrable problems and therefore the second question as to whether or not mandatory pre- or post-trade transparency would solve them, does not arise.

Q6: To what extent could recent and upcoming technological and market developments in relation to the instrument markets under review contribute to a relatively inexpensive extension of mandatory transparency or render it unnecessary?

The FOA believes strongly, as stated previously in this response (and for the reasons given) that transparency in the markets which fall within its purview should not be mandated beyond what is already required or in place and that the need for any further level of transparency should be a natural outcome of competition, market development (which will increasingly be informed by technological changes) and, where it is brought to bear, buy-side pressure. On that basis, any increase in transparency is more likely to be necessary and appropriately tailored on a market-by-market basis, so meeting the cost/benefit test in a natural and evolutionary manner.

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?

In large part, this question has been the subject of answers in the main introductory paragraphs in this report (principally in section 2), but the FOA would point to lack of direct retail participation, professional and wholesale nature of the markets, the different economic functions served by them and the fact that there is already prevailing lower levels of transparency operable in the markets. The FOA would also reiterate its concern that the Commission seems to be looking only at mandatory transparency (albeit on a graduated basis), rather than where mandatory transparency as opposed to market-driven transparency may be appropriate.

Q8: No comment

Q9, 10 and 11: FOA interface/reliance on academic or institutional papers

The FOA has not drawn its response from any such literature, but has consulted with its members.

Q12: What similarities, and what differences, are there between US and EU markets that should be borne in mind when seeking to draw inferences from the TRACE experience in the US?

The FOA would defer to those trade bodies with a cash equity remit.

Q13: Do you agree that only EU-level action would be appropriate in the present case?

On the basis that there are no known identified problems in the markets covered by the FOA, the question does not apply, but, if it did, the FOA would urge the Commission to consider – in line with the better regulation agenda and the Lamfalussy principles – the role of market forces in this context.

Q14: See answer to Q13.

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 FOA believes that these are probably the core options, but would emphasise that self-regulation is not necessarily the same as market-evolution. In other words, the option of self-regulation could come about through the development and voluntary observance of industry standards, whereas reliance on market-evolution would not be dependent upon the delivery of such standards, but rather on naturally driven changes in the market place.

For this reason, the FOA believes that reliance on “market-evolution and forces” is really a fifth option and not a sub-set of any of the identified four options.

Q16: Would you, in light of your answers to the other questions, favour any of the four (five?) options?

The FOA, as might be expected, is a strong supporter of market forces and, where appropriate, buy-side pressure rather than regulatory-driven mandated transparency, but recognises that this preference has to be subordinated to the better regulation criteria identified in paras 1.3 and 1.4 in this response, which may generate the need for regulatory action. In professional markets, the need to recognise market differentiation is critical and the FOA believes that this may be best achieved through, as previously stated, natural market pressures or, possibly, through the development of industry guidance or voluntary actions, rather than mandated transparency. However, to reiterate the point, the FOA does not believe that, in the markets covered by it, there is any evidence which would justify mandated transparency.