

15 September 2006

Laurence White
European Commission
Internal Markets and Services DG
Brussels
Belgium

Dear Lawrence

Response to Call for Evidence: 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

The Investment Management Association (IMA) is pleased to offer comments in response to the Commission's Call for Evidence.

IMA represents the UK-based investment management industry. IMA members include independent fund managers, the asset management arms of retail banks, life insurers, investment banks and occupational pension scheme managers, and are responsible for the management of over €4 trillion of funds (based in the UK, other parts of Europe and elsewhere). As at June 2005 IMA members were responsible for the management of fixed income assets to a value of €1338 billion.

Our response is principally concerned with the cash bonds asset class. We provide answers based on our position as users of these markets. We leave it to the intermediaries – dealers and their representative associations – to provide more detailed information about market structure and practices.

The secondary market in bonds is very important to our members. Our members are therefore anxious that what works well in the bond markets should not be made subject to untested change. It is important that any proposed solution to an identified problem should deliver the intended result. We are aware that some regulators in Member States are concerned that retail clients do not get 'fair' treatment in the bond market. We cannot comment specifically on whether this is the case, but we do point out that enhanced investor protection provisions in MiFID have not yet come into effect. It is possible that, as direct retail investors gain added regulatory protection from MiFID, for instance in relation to investment advice, any such imbalance may be redressed. Further transparency could be of quite minor consequence when compared to these enhanced regulatory protections.

Research into bond markets

There is little published information on European bond markets. In part to address this information void we, together with other associations representing both market users and providers of market liquidity and services, commissioned two independent academic studies on the European government and corporate (investment grade) debt markets. The research was published in May 2006. Both research reports were conducted by the Centre for Economic Policy Research (CEPR), using two teams of European researchers¹.

Copies of the report have been made available to Commission staff. Our members support the findings of the research and draw your attention to the following important points which were substantiated in it:

- the empirical analysis showed that spreads were tighter in the euro bond market than in the US corporate bond market. This appears to be consistently the case over a period of nearly three years, notwithstanding that the US markets had introduced full post-trade transparency, and the euro bond markets had not;
- competition would therefore appear to be a key driver of liquidity and transparency a (relatively) poor substitute;
- imposing pre-trade transparency via regulation would be risky. As the researchers note, it would, in effect, amount to a form of re-engineering of the market microstructure, with little ability to predict the outcome;
- on the other hand, some post-trade transparency may offer benefits. Although there are clearly risks associated with post-trade transparency, these could be mitigated by a careful approach;
- ideally, changes to the transparency regime should be market-led.

We also would prefer to see market-led change. In particular, we believe it would be beneficial for a controlled experiment, or experiments, to be carried out in relation to post-trade transparency, designed to establish whether additional transparency would offer demonstrable value to the market, or the reverse. Any such experiment would need to be conducted with transparent terms of reference and with independent oversight. Professor Biais, in his study of the corporate bond markets, draws attention to a real-scale experiment conducted by Goldstein Hotchkiss and Sirri (2005)². This approach seems to offer much of what would be needed to assess, qualitatively and impartially, the impact of introducing some post-trade transparency.

Research into high yield debt is also currently underway and is expected to be complete towards the end of this year. This will encompass an extensive empirical study, together with an overview of the workings of the market.

¹ *European Government Bond Markets: transparency, liquidity, efficiency* Portes, Dunne, Moore (Centre for Economic Policy Research); *European Corporate Bond Markets: transparency, liquidity, efficiency* Biais, Declerck, Dow, Portes, von Thadden (Centre for Economic Policy Research)

² *European Corporate Bond Markets: transparency, liquidity, efficiency* page 16

The Commission will also be aware of the FSA Feedback Statement, FS 06/4, to their earlier discussion paper on transparency DP 05/5. For your information we attach our submission to FSA in respect of DP 05/5.

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

No. The scope of the Report seems reasonable.

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

Yes. The scheme proposed by the Commission seems appropriate for the review.

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

We have not identified a missing rationale. However, we point out that the policy rationales identified are appropriate to an open review of the workings of a market, whereas the current review is directed only to consider the introduction of transparency. Although we realize that the Commission is bound to conduct the review in these terms, nonetheless it is a missed opportunity for the legislation to have prefigured the solution to a problem that may not exist.

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

Yes, we agree.

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?

Clearly equities are different from non-equity instruments. It does not follow that lower levels of transparency, or indeed any transparency at all, can be justified in those terms. Transparency is a means to an end, not an end in itself. If useful comparisons are to be drawn with the equity markets, it is important that as well as looking at the different market structures, the different purposes for which debt and equity are held and the different redemption mechanisms available to investors are also considered.

Publicly issued equity can only be transferred through the secondary markets: there is no redemption mechanism. Publicly issued debt, by contrast, is redeemable at term. The investor in a bond provides what is, in effect, a fixed term loan to the company (or government or other body, as appropriate). In return, the investor receives a fixed income and, at term, a return of principal. In this respect, bonds share as many characteristics with a term deposit as they do with a share.

Although credit and other events can subsequently intervene to affect an investor's buy and hold strategy, the presumption at issuance is that the issuer will meet his obligations and redeem the debt. This expectation, combined with the known flow of income, is what shapes the nature of supply and demand, and in consequence the market structure for secondary trading. We point this out to highlight the inappropriateness of developing policy based on an equity market model

Q8 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?

We refer you to the two CEPR studies referred to above. In due course, we would expect that you would also wish to refer to the study of high yield debt also mentioned above. IMA holds little data of direct relevance to this debate. You will note that the CEPR studies had access to very rich data, both real-time transaction information and considerable quote information. This was obtained from various sources, the most important single source being data reported through the International Capital Market Association's TRAX system.

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


The Commission's list is fairly comprehensive (albeit note that the CEPR studies have been misidentified as emanating from the Centre for European Policy Studies (CEPS): CEPR is the Centre for Economic Policy Research, a network of senior academics who conduct research on issues affecting the European economy; an entirely different organisation from CEPS). In addition we refer you, in due course, to the research currently underway in respect of high yield debt, which is expected to be available towards the end of the year.

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

Research based on equity markets is interesting but cannot be conclusive in relation to other financial markets. We refer you in particular to the literature review in the CEPR study on corporate debt for a pertinent discussion of this point³.

Please call me if you would like to discuss this letter.

Yours sincerely



Jane Lowe

³ *European Corporate Bond Markets: transparency, liquidity, efficiency* Chapter 2