

Response from the MTS Group to the European Commission's Call for Evidence

Pre- and Post-trade transparency provisions of MiFID in relation to transactions in classes of financial instruments other than shares

Introduction

Further to the 'Call for Evidence' issued by the European Commission on 12 June 2006, the MTS Group ('MTS') is grateful for the opportunity to contribute to the debate regarding extending transparency provisions to non-equity instruments. We are able to provide an expert point of view because we of our long-established presence in the European government bond market. Our leading market presence can be illustrated by number of markets we operate – over 20 wholesale markets in addition to the B2C platform, BondVision, and MTSNext, the company that manages the EuroMTS Indices. The average transaction volumes across the group are up to 90 billion euros a day (single counted) for the inter-dealer market and approximately 2.5 billion euros per day on BondVision (B2C).

The role of MTS is to establish and organise an efficient market place for all types of participants. It is based on the pre and post-trade transparency principles – prices are tradable by any participant. MTS considers the interests of all participants in the fixed income markets which include issuers, liquidity providers, regulators, and investors which is an indication that we do not favour one type of participant over another.

The European fixed income market has entered a virtuous circle since the inception of the Euro and MTS has greatly contributed to its efficiency; our platform has standardised the practice of fixed-income trading which has consequently reduced costs and facilitated cross-border activity across Europe. Our transparency provisions have enabled the fostering of competition amongst participants and created important ancillary benefits namely liquidity, efficiency and cost reduction. These primary and ancillary benefits have permeated into the government, quasi-government and covered bond markets. MTS continues to extend the benefit of its market model to other asset classes within the fixed income market. The challenge is to extend these benefits to other asset classes of the very diverse fixed income markets.

Open issue for discussion

We believe that pre-trade transparency can only serve its purpose if all market operators provide their information to a single aggregator of data, thereby providing investors with a real best market price.

Generally, MTFs and regulated markets fulfil their obligation with regards to pre-trade transparency by providing data to data vendors on reasonable commercial terms.

Data vendors play an important role to the efficient operations of the markets by acting as aggregators of information and displaying pre-trade transparency. We feel it is important that these activities are performed in a controlled, efficient and reliable manner. Since data vendors perform such a crucial role in ensuring transparency in the markets, it would be appropriate if this activity is regulated. It is also important that this role is independent and should not be combined with that of a market operator due to the resulting conflict of interest and potential implications for competition, transparency and efficiency.

Given the potential of data fragmentation post-MiFID, it is a concern for market participants to be able to rely on clean and reliable data that provides them with a full price-flow of their market. By regulators mandating price aggregators to receive data from all relevant data sources then disseminating this data to vendors would ensure that the end-users are receiving an endorsed flow of data which provides an added assurance for them to be accountable for their decisions.

Mandating aggregators would also ensure that data vendors do not disseminate data that is utilised to create a superficial market. For example, banks may quote tight prices that may not be firm executable prices. An investor may find, whilst undertaking its price discovery process, that the tighter price no longer exists. However, the impression to the outside world is that the provider of the tighter price is more competitive than their peers (which is not the case). Prices should be reliable, executable and available on a reasonable basis and not quoted as 'headline rates' at expense of the investor.

For post-trade transactions, MiFID grants investment firms a greater choice over the venues to which they will be able to report these details. The aim is to enhance competition and reduce the costs of post-trade publication. This may however create a risk of greater fragmentation of post-trade information. To mitigate that risk we draw your attention to the FSA's guidance to establish and encourage firms to report to Trade Data Monitors'¹.

Responses to the Questions:

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

We believe that the scope of the Report attributes the correct context in the decision-making process towards implementing any transparency provisions to non-equity instruments. We agree that these instruments encompass several asset classes that require a subjective approach in determining their transparency requirements. A binary scenario to decide full or no provisions for non-equity instruments would mean the implementation of a blanket regime that may be harmful rather than an added value tool for MiFID.

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

Whilst we welcome that the Report has widened the scope the classification scheme of Art 4(1)(18) and (19) of the Directive, we would like to highlight the characteristics of non-equity products that would merit close study to prescribe full, partial or no transparency on both a pre- or post-trade basis. For fixed income debt instruments this would include the frequency of issue, size of outstanding debt, credit rating, and transaction size. We would therefore suggest the use of a 'transparency matrix' (Annex 1) which highlights these different characteristics of traded products using a multi-variable scenario to ascertain the most appropriate level of transparency. The coefficients we have used are arbitrary and based on empirical observation.

Ultimately, we should be prepared to identify all the relevant permutations for which extending transparency will serve as an attraction for investors to fixed-income instruments and consequently increase activity within that market. Thus, the implementation of transparency should be seen as a tool to achieve this aim.

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

¹ FSA Consultation Paper CP 06/14 "Implementing MiFID for Firms and Markets" (July 2006)

Greater market transparency would give more information, potentially to the whole market, about trading interest or order flow. This would expose more private information, not just about trading interest or order flow, but also, indirectly, about fundamentals.

We would also highlight that the rationales should be seen on a more granular level to consider the effect of any transparency provisions on wholesale and retail investors separately. We would also point that there may be other structural issues that may be affecting the participation of retail investors in non-equity markets – for example, the lack of education amongst retail investors (compared to their knowledge in equities) and the avoidance of dealers to trade in retail size. Thus, we propose that any transparency provisions should avoid an altruistic approach and be balanced to provide sufficient value to investors.

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

We agree that by their very nature ETFs have high levels of pre- and post-trade transparency in accordance with their exchanges' listing requirements. To promote pre-trade transparency for OTC (namely block) trades, like fixed income instruments, may precipitate an exit by dealers to eliminate their risk of position exposure and this may in turn reduce liquidity. As the Report suggests, secondary trading of ETFs is limited outside the scope of the exchanges.

Question 5: 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?

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

The possible policy rationales in the Report are set out to support mandatory transparency. We have already highlighted our preference for there to be a subjective approach towards any implementation of transparency requirements. Thus, the implementation of full transparency to an instrument may not have the ancillary benefits (such as increased liquidity) that one would suppose but the potential of ancillary harm. Whilst we support transparency's policy objectives – namely the four policy objectives that fall under the umbrella of transparency: financial stability, retail investor protection, competition among financial service providers, capital markets that discourage fraudulent and criminal activity; retail investors would undoubtedly be able to participate on a level playing field but publishing post-trade data shortly after execution, for example, may lead to withdrawal of dealer interest and liquidity particularly in illiquid products; they would not want to imply open positions to the market which would lead to loss of competition overall. Indeed, another situation arises where, in illiquid markets, dealers commit capital to help investors acquire or liquidate positions. We would not wish to see regulatory action adversely impact this type of liquidity provision.

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?

Several non-equity instrument classes in markets such as bonds are dynamic in nature due to changes in market and technological requirements. It is important for that the type of transparency mandated should not stifle the market model. Examples of these changes are:

- i) the ongoing evolution of new bond structures – by nature, less liquid
- ii) growing market-led transparency via e-trading eg MTFs and quote vendors - has increased market transparency and dealers' ability to offer more competitive prices to customers.

iii) the rising number of bond indices eg EuroMTS Indices - allows for new reference points for prices hence an overall growth in market-led transparency information.

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?

In the EPDA Response to FSA discussion paper 05/05 on “Trading transparency in the UK secondary bond market” (December 2005), several differences were highlighted regarding equities and bonds. However, whilst we recognise that these may exist (and, by the same token, counter-arguments) we believe that it is important to debate the implementation of transparency by looking at non-equity instruments (and the type of non-retail/retail participants) on a case-by-case basis. This would entail making appropriate decisions regarding implement transparency provisions separately on a pre-trade and post-trade basis and also the nature of the transaction itself (eg block trades).

Further, we should concentrate on whether there would be a market failure without mandated transparency rather than the issue of transparency provisions for equities should be transposed to the fixed income markets *en masse*.

Question 8: 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?

If requested, we would be happy to provide relevant data for the purpose of this consultation.

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

Green, R.C., B. Hollifield and N. Schüroff (2004); “Financial Intermediation and the Costs of Trading in an Opaque Market”, paper presented at the 2004 MTS conference in Vienna

Lee, R. (2002); Capital markets that benefit investors: A survey of the evidence on fragmentation, internalisation and market transparency; Oxford Finance Group

Piga, G., Paesani P (2006); “Transparency in the European bond market”, forthcoming publication in Transition Studies Review, 2007, vol. 46

Question 10.: What conclusions do you draw from the existing academic debate and the ongoing work being conducted by 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?

[Response to Q10 and Q11]

Academic literature has provided useful information towards the transparency discussion; however, we would like to reinforce that market practitioners are well-disposed as they are able to provide pragmatic advice based on empirical observation. We would question those whom would mention that enhanced transparency would naturally lead to increased liquidity, for example. Whilst this is an ideal scenario, commercially this may not the case as we believe liquidity does not have a direct correlation with increased transparency.

We would like to see more academic work that supports a non-binary approach towards implementing transparency to non-equity instruments and its consequent benefits.

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?

Whilst there are obvious benefits of TRACE – namely the reduced transaction costs for investors, the magnitude of the impact is not clear. There are significant differences in the UK and US corporate bond market, for example – there is greater pre-trade transparency compared to the US. Would enhanced post-trade provisions provide for a more apparent benefit given the current market situation? Retail participation in corporate bonds US and Europe is also variable - thus, the EC would have to determine whether the implementation would add value to the existing scenario.

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?

We believe that any implementation schedule should avoid any regulatory asymmetry between all EU countries. Promoting a consistent and harmonious approach would reduce the exposure of MiFID having ‘country-risk’.

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?

No response

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?

We believe the pre- and post-trade options proposed are reasonably high-level to allow for a suitable discussion on this topic.

Transparency provisions should be extended to those markets which the industry believes are currently experiencing market failure and where, post-implementation, a stimulation of activity would occur.

We would not suggest a mandatory MiFID-like system (obligation to put forth real-time executable bond prices for all systematic internalisers and alternative trading venues and for all bonds, transparent order book, both pre-and post-trade transparency) as existing competition, market-driven transparency, the interaction between cash and credit derivatives markets, and regulation seems sufficient to deliver efficient pricing and fair executions particularly by MTFs.

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:

- **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 have already suggested the use of a 'Transparency Matrix' in Question 2

Conclusion

The European bond market is made up of many segments characterized by different issuers, security types, investors' preferences and risk profiles. These segments have also different market structures, varying levels of liquidity and of pre- and post-trade transparency. The appropriate level of transparency on each segment depends on many different factors: the size of the market, frequency of trading, participants in the market, credit ratings of the issues, trading methodology, potential effects of disclosure on the liquidity of the market, whether the bonds are listed or not.

Implementing any type of transparency provision that would affect an existing market's status quo should be measured by the potential of increasing confidence within that market and an ancillary benefit would lead to deeper levels of liquidity. If increased activity is not a direct result of any change then we would seriously question the application of such provision in the first instance.

Empirical evidence tells that within the European bond market transparency varies from high to low depending on the asset class. The economic literature suggests that quote-driven markets and continuous-auction order-driven markets tend to be more transparent than call or batch trading order-driven markets and that for quote-driven, multiple-dealer markets, greater transparency can increase liquidity, first, by reducing the negative impact of information asymmetry between more informed investors and less informed dealers and second, by inducing greater overall investor participation. The presence of B2B electronic platforms offering real-time quote-driven executable prices provides a transparency standard to the bond market as a whole. As the situation stands, the information radiating from this segment of the European bond market illuminates the market as a whole.

The main risk to the status quo is posed by ongoing consolidation in the European banking sector coupled with the possible development of systematic internalisation in the bond market. Trading fragmentation coupled with the strong negotiating power of a few large dealers, such as is the case in the United States, may create diseconomies of scale in terms of liquidity (smaller multiple trading venues offering each less liquidity than larger ones) and transaction costs (smaller trading venues charging higher fees than larger ones) and a capture-of-uninformed-investors problem. These problems would be obviously exacerbated by a lowering of transparency standards were a partial extension of MiFID be accepted.

If trading fragmentation and systematic internalisation lay in the future of bond trading, extending MiFID to the bond market may be good for society as a whole. What is important to stress, however, is that if MiFID transparency provisions are to be extended to the bond market it must be "real" transparency which is extended and not "fake" one. Based on the economic literature and empirical evidence reviewed above, "real" transparency has been defined as the pre-trade dissemination of real-time executable prices and a transparent order book making it possible for market participant to know in real time "where the market stands". Under current provisions, this kind of information is available in the European bond market if not directly to everybody, at least directly to dealers and professional investors via data vendors and retail clients through delayed market data via multiple price sources currently available through the internet. Anything weakening of the current transparent and competitive core of the European bond market would run counter to the purposes of MiFID itself.

[Annex 1 is a separate file]