



EUROPEAN COMMISSION

Internal Market and Services DG

FINANCIAL SERVICES POLICY AND FINANCIAL MARKETS
Director

Brussels, 23.11.06 5398
G3 D(2006) 16552

Mr John Holland
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London EC2 M2PP
United Kingdom

Subject: Request for advice on non-equities markets transparency

Dear John,

Many thanks for agreeing to lead the work of the European Securities Markets Expert Group Sub-group on non-equities markets transparency.

In connection with the Commission's work under Article 65(1) of the MiFID, I enclose a mandate for advice on a range of topics.

You will note that we now anticipate receiving advice from ESME by the end of June.

Yours sincerely,

[signed] David WRIGHT
Director

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Mandate to ESME for advice

Possible extension of the scope of the provisions of Directive 2004/39/EC concerning pre and post-trade transparency obligations to transactions in classes of financial instruments other than shares

This mandate requests ESME's advice on certain issues concerning the possible extension of the scope of the provisions of Directive 2004/39/EC (MiFID) concerning pre and post-trade transparency obligations to transactions in classes of financial instruments other than shares.

This mandate is to ensure that the Commission has adequate technical background to be able to complete its report under Article 65(1) of the Directive (the Report).

The present mandate takes into full consideration the agreement on implementing the Lamfalussy recommendations reached with the European Parliament on 5 February 2002. In this agreement, the Commission committed itself to a number of important points, including full transparency. For this reason, this mandate will be published on DG Internal Market's web site and the European Parliament duly informed.

1. BACKGROUND AND LEGAL FRAMEWORK

The European Commission is to report to the European Parliament and the Council as to the possible extension of scope of the pre- and post-trade transparency provisions of MiFID to transactions in classes of financial instrument other than shares. The Report is required by Article 65(1), which provides that:

By 31 October 2007, the Commission shall, on the basis of public consultation and in the light of discussions with competent authorities, report to the European Parliament and to the Council on the possible extension of the scope of the provisions of the Directive concerning pre and post-trade transparency obligations to transactions in classes of financial instrument other than shares.

The purpose of this mandate is to seek technical advice in order to provide foundations for Commission's work on the Report.

2. CONSULTATION AND SOURCES OF ADVICE

Article 65(1) quoted above mentions the Commission acting 'on the basis of public consultation and in the light of discussions with competent authorities'.

The White Paper on Financial Services Policy 2005-2010 set out the Commission's commitment to open and transparent consultation:¹

¹ *Op. cit.* at paragraph 2.1.

Open consultations (including with stakeholder groups) will continue to play a central role and will be required before any legislation is deemed necessary. The Commission will continue to publish responses received to its consultations, practical summaries and feedback statements.

In fulfilment of this commitment, Commission services published a Call for Evidence on 12 June 2006, which was open until 15 September 2006. A feedback statement summarising the feedback received is available on the DG Internal Market and Services website.²

In parallel to this request advice is sought from the Committee of European Securities Regulators (CESR). A copy of our mandate to CESR for advice will be made available on our website.

ESME should also note that organisations such as the International Capital Markets Association and the 13 Trade Associations that responded jointly to the Call for Evidence are understood to be working on proposals for self-regulatory changes to enhance bond market transparency, particularly for retail customers. ESME should be aware of what is being planned.

3. THE PRINCIPLES TO WHICH ESME SHOULD HAVE REGARD

As regards its working approach, ESME is invited to take account of following principles:

- The principles set out in the Decision³ establishing ESME;
- ESME should provide comprehensive advice on the matters described below
- ESME should address to the Commission any questions which arise in the course of its work.

4. QUESTIONS IN RELATION TO WHICH ADVICE IS SOUGHT

Please consult **Annex I** for a list of questions in relation to which advice is sought. For further background to some of the questions raised, please consult **Annex II**.

5. DUE DATE

ESME's advice is sought by the end of June, 2007.

² http://ec.europa.eu/internal_market/securities/isd/mifid_reports_en.htm

³ See Decision 2006/288/EC, OJ L 106, 19.4.2006, p. 14, http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_106/l_10620060419en00140017.pdf

Annex I

Questions on which advice is sought

General approach

ESME is asked to react to the feedback statement and the responses to the Call for Evidence and to provide its comment thereon.

ESME is asked to address the markets for the following instruments ('cash bond markets') in particular:

- Cash government and supranational bonds
- Cash investment-grade⁴ corporate bonds
- Cash high-yield⁵ corporate bonds

However, ESME is asked to consider other markets to the extent it is necessary to do so in order to:

- answer aspects of the questions below that relate specifically to other markets; or
- fully address the questions below in relation to the cash bond markets.

Specific questions

In particular, ESME is requested to consider the following specific questions:

1. Does ESME consider there to be convincing evidence of a market failure with respect to market transparency in any of the instrument markets under review?
2. What evidence is there that mandatory pre- or post-trade transparency would mitigate such a market failure?
3. To what extent can the implementation of MiFID be expected to change this picture?
4. Could it be feasible and/or desirable to consider extending mandatory transparency only to certain segments of the market or certain types of investors?
5. A number of suggestions have been put forward by respondents to improve transparency of the markets in a way that does not involve market transparency in the sense used by MiFID, such as:
 - a) Transparency of aggregate net risk positions on the part of particular trading venues or market participants.
 - b) Transparency of overall market activity.

⁴ i.e., bonds having one of the top four ratings of each of the major credit ratings agencies

⁵ i.e., corporate bonds other than investment-grade bonds

- c) Increased transparency of effective margins and increased periodic reporting obligations relating to securitised derivatives.

Does ESME see merit in any of the suggestions put forward of this kind? More specifically, does it consider there to be a convincing case for the need to mitigate a market failure by adopting one or more of them in any of the non-equity markets under investigation?

- 6. Does ESME support moves towards establishing a self-regulatory solution to issues of:
 - a) retail access to information about bond market transparency?
 - b) the need for better information on overall market activity?

Annex II

Additional background to questions on which advice is sought

Additional background on aggregate net risk positions and overall market activity

From AMTE's response to the Call for Evidence:

6. There is a strong case for the estimation and publication of aggregate market positions and other risk/return measures covering all categories of financial instruments. This would require cooperation from all European market regulators working in conjunction with market players and trade bodies to establish measures of aggregate market positions. The absence of published market wide indicators of aggregate positions is in our opinion the largest single failure in the European financial markets. (p. 9)

All investors, but particularly unsophisticated retail investors, are also likely to be better served by measures that warn them of large positions being built up in the market than by measures which improve marginally the price they obtain for individual transactions, i.e. by increased macro rather than micro transparency. Individual market makers are unable to judge to what extent individual market positions have been built up as some market participants may trade with a large number of market makers. No one knows the overall positions built up by individual players or by the market as a whole in the OTC market. Regulators should be in a position to consolidate market maker positions and thus to estimate aggregate market positions. The results of such studies should therefore be published and allow participants to judge to what extent prices have been influenced by large positions. Such type of transparency, which is supposed to improve liquidity under stress conditions and that we call systemic or macro transparency as distinct from what we call micro transparency, is referred to in the ECB Occasional paper. There is a good precedent for this in the data published by regulated futures exchanges which show the aggregate open positions held. (p. 20)

As discussed in our submission, we believe that there is a case for regulators to compile and to provide the market with more information on systemic risk based on estimation of aggregate risk positions built up by the market. Information on net positions by trading venue may assist in improving search liquidity in this respect. The technical difficulties of deriving an aggregate risk position not only for a given trading venue but for the market as a whole should be carefully analysed by the Commission and be consulted with the relevant market participants. (p. 54)

Additional background on increased transparency of effective margins and increased periodic reporting obligations relating to securitised derivatives

From BVI's response to the Call for Evidence:

As it stands, pricing of securitized derivatives is the sole privilege of issuing banks. This principle applies not only to off-exchange distribution, but also to trades on exchange where the respective bank usually holds the monopoly on market-making function. For example, the rules of EUWAX2, the marketleading platform for trades in derivative securities in Germany, permit only execution of trades within the bid-ask spread determined by the issuer or respectively authorised market-maker. As the EUWAX-rules also prohibit short sales in derivative securities, no price correction mechanisms can be applied in order to ensure that the prices offered by issuers correspond with the fair value of respective underlying.

Consequently, issuing banks are free to include healthy profit margins when calculating prices of derivative securities. As a rule, the highest margins are being attributed to initial price offerings with significant margin reductions taking place towards the end of maturity period when banks start to pay off their investors. Apart from simply structured products like certificates on

major performance indices, where the high competition among issuing banks provides for product comparability and near-adequate pricing, average retail investors have no means to control or at least comprehend the price-building mechanism applied to certificates. Still, this severe lack of transparency is aggravated in cases where the issuer also determines the price of the underlying.

In addition, under the rules of EUWAX as well as other trading platforms, issuing banks are entitled to annul transactions in certificates which are executed at prices “clearly diverging from market prices”. As determination of market prices is effectively dictated by issuers, there are reported cases in which banks drastically changed the quoted price of a security to allow for rescission of less profitable trades. Thus, applications for rescission which can be filed up to 24 hours following the execution of a trade eliminate even the slightest risk of missed profits due to incorrect price calculation. This practice appears intolerable in light of the fact that the market for derivative securities is frequented by retail investors and has already reached a size of Euro 100 bn in Germany.

With regard to ABS market, there are pressing problems concerning postissuance investor information. Some ABS, in particular CDOs, do not publish periodical investor reports pertaining to the issued tranches of securities, even though these are listed on regulated markets. Also, in spite of ad-hoc rules of the Market Abuse Directive³, there is no clear obligation to disclose all information directly affecting market prices of listed securities (e.g. portfolio information, significant changes of operating figures, material shortfalls). Similar problems affect corporate bonds of issuers whose shares are not listed on regulated markets.

Considering markets for derivative securities, pre- or post-trade transparency in the narrow sense would not be sufficient. The major problem concerns rather the complete lack of information with regard to the price forming mechanism. Hence, disclosure of pricing components with a separate specification of the effective margin is needed in the information materials to be provided to investors.

Also, transparency deficiencies affecting ABS and corporate bond markets call for regulatory action in terms of general market information. In our opinion, much can be done by introducing periodic reporting obligations with specific regard to securities listed on regulated markets. Moreover, a consequent extension of ad-hoc communication requirements to cover inside information directly concerning the issued securities would also help to provide investors with reliable indicatives for price-sensitive issues. (pp. 5-6)

Additional background on self-regulatory solutions

From the 13 Trade Associations’ joint response to the Call for Evidence:

Nevertheless, both the FSA and the CEPR suggest that there might be some merit in considering whether or not a benefit might arise from further ‘formal’ post-trade transparency in corporate debt markets. However the paucity of evidence of ‘problems’ taken together with a lack of evidence that benefits will arise, and some evidence that, mis-handled, more formal posttrade transparency could lead to a decline in liquidity, leads to a conclusion that an investigation of more formal post-trade transparency needs to be carefully handled, and ideally industry-led rather than imposed by regulators. We support this conclusion, note the related views of some institutional investors and plan to work with our members and other associations on this matter. A key element of our work will be to consider the extent to which the availability of pre-trade price information, when considered together with infrequent trading demand for most bonds means

that benefits from further 'formal' post-trade transparency are unlikely. We will keep the Commission informed of our progress. (p. 8)

From ICMA's response to the Call for Evidence:

These reservations notwithstanding, as an SRO, ICMA, in consultation with its members, is constantly examining its own rules, recommendations, procedures and the services it offers to its members and market users and participants more generally. In the last two years, for example, ICMA introduced icma.org which provides easy access for subscribers to the over 20 year of data on Europe's bond markets including secondary market data and prospectuses of over 200,000 issues. This year it has rolled out substantial improvements to TRAX, designed in particular to respond to the clear market need for more efficient clearing, settlement and post-trade management in the rapidly expanding repurchase agreement market, daily volume in which substantially exceed volumes in the cash market for bonds.

We have also been discussing the issues concerning bond market transparency for some time with our liquidity providers and have now extended that process to our buy-side members to establish whether, in their view, there is more that can and should be done at the self-regulatory level to further enhance the levels of post-trade transparency in international debt securities. We will also hold discussions with other representative associations from the fund management community. ICMA is committed to pursuing this work with an open mind as to the eventual outcome. We seek to make a positive contribution to the debate and to do so, on the basis of securing as great a degree of consensus as possible among the diversity of interests reflected in ICMA's membership.

We will return to the Commission early in 2007, with our conclusions which we believe will have the support of a critical mass of buy side and sell side participants in Europe's bond markets. We will then be anxious to engage in substantive dialogue concerning the self-regulatory option. In particular, assuming we proceed with phased or experimental introduction of enhanced transparency, we would welcome close cooperation with and advice from the Commission and CESR, and indeed the academic community, on the details of our plans, their relevance to the appropriate regime for best execution in dealer markets and on how to assess whether there are any adverse effects on liquidity. (p. 11-12)