



EUROPEAN COMMISSION

Internal Market and Services DG

Brussels, 5 September 2007

**Markets in Financial Instruments Directive (MiFID)**

**Public hearing on non-equities markets transparency**

**Brussels, 11 September 2007**

**Background paper**

*DG Internal Market and Services working paper. This paper was drafted under the sole responsibility of the Directorate General for Internal Market and Services, and does not commit, or necessarily reflect the views of, the Commission.*

## **Markets in Financial Instruments Directive (MiFID)**

### **Public hearing on non-equities markets transparency**

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#### **Background paper**

### **1. INTRODUCTION**

The European Parliament and the Council have asked the Commission to report on the adequacy of the level of pre- and post-trade transparency in classes of financial instrument other than shares (the Report). The Report, required by Article 65(1) of the Markets in Financial Instruments Directive (MiFID)<sup>1</sup>, is planned to be adopted in Q1 2008. The Commission is required to report 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 Report is being prepared in accordance with the Commission's initiative on better regulation<sup>2</sup> and its guidelines on impact assessment.<sup>3</sup>

The present document constitutes a background paper for a public hearing to be held in Brussels on 11 September 2007. The agenda of the public hearing is set out in **Annex I**.

### **2. OVERVIEW OF DEVELOPMENTS**

#### **2.1. Responses to the Commission's Call for Evidence**

The Commission services issued a Call for Evidence in June 2006.<sup>4</sup> A total of 59 organisations responded. A feedback statement summarising the responses, together with

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<sup>1</sup> Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, OJ L 145, 30.4.2004, p. 1 (as amended by Directive 2006/31/EC of the European Parliament and of the Council of 5 April 2006, amending Directive 2004/39/EC on markets in financial instruments, as regards certain deadlines, OJ L 114, 27.4.06, p. 60).

<sup>2</sup> See Press Release number MEMO/05/340, Brussels, 27 September 2005 for a succinct summary. See <http://tinyurl.com/to5x6>.

<sup>3</sup> Impact Assessment Guidelines (SEC(2005) 791. See [http://europa.eu.int/comm/secretariat\\_general/impact/docs/SEC2005\\_791\\_IA%20guidelines\\_annexes.pdf](http://europa.eu.int/comm/secretariat_general/impact/docs/SEC2005_791_IA%20guidelines_annexes.pdf).

<sup>4</sup> [http://ec.europa.eu/internal\\_market/securities/docs/isd/call\\_for\\_evidence\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/isd/call_for_evidence_en.pdf)

the full text of the non-confidential responses, was published in November 2006.<sup>5</sup> The main conclusions were as follows:

- Most respondents expressed opposition in varying degrees to the introduction of mandatory transparency obligations in the markets for financial instruments other than shares (non-equity financial instruments).
- Although most respondents opposing mandatory transparency requirements rejected both pre-and post-trade transparency, respondents tended to be less opposed to post-trade transparency. At the same time, however, many respondents doubted whether post-trade transparency would be useful in markets where some instruments are rarely traded and where a number of factors (e.g. volume, counterparty, prevailing market interest rates) will influence price.
- A smaller number of respondents advocated awaiting the results of MiFID before deciding whether to impose additional transparency requirements beyond equity markets. Such respondents considered that MiFID would have profound impacts on securities markets in the Community and action now would be premature.
- Those who were in favour of self-regulatory solutions only expressed a preference for an increase in post-trade transparency, but not in pre-trade transparency.
- Those who were open-minded on the need for change tended to advocate separate consideration of retail and wholesale investors and of different types of non-equity securities. They also tended more strongly to favour a moderate level of post-trade transparency for more liquid corporate bonds, and tended to be against mandatory pre-trade transparency.
- Those who were positively supportive of change emphasised that mandatory transparency would lead to greater fairness in price discovery and lessen the information gap between different types of investors.

## **2.2. Committee of European Securities Regulators (CESR)'s advice**

### *2.2.1. Initial assistance*

In August 2006, the Commission requested CESR to provide initial assistance on the issue of non-equity market transparency by conducting a fact-finding exercise in relation to cash bond markets. In October 2006, CESR provided its response<sup>6</sup> to that request. CESR's analysis revealed that:

- There was a lack of comprehensive, harmonised information on the nature and size of EEA bond markets. As a general observation, the information available on government bonds was viewed as more reliable than that available on corporate bonds.

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<sup>5</sup> Feedback statement: [http://ec.europa.eu/internal\\_market/securities/docs/isd/feedback\\_statement\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/isd/feedback_statement_en.pdf). Full text responses: [http://ec.europa.eu/internal\\_market/securities/isd/consultation/mifid\\_replies\\_en.htm](http://ec.europa.eu/internal_market/securities/isd/consultation/mifid_replies_en.htm)

<sup>6</sup> [http://www.cesr-eu.org/index.php?page=contenu\\_groups&id=53&docmore=1#doc](http://www.cesr-eu.org/index.php?page=contenu_groups&id=53&docmore=1#doc)

- Pre- and post-trade transparency requirements in Member States were generally set up for/by regulated markets and, in some cases, multilateral trading facilities (MTFs).
- There are some common characteristics in bond market users and structures in the EEA, but also some key differences between Member States. Such differences relate, amongst other things, to the level of direct retail involvement in the bond markets. Following the responses to the Call for Evidence, the Commission services issued CESR with a request for advice.

### 2.2.2. *Technical advice*

In November 2007, the Commission services issued a mandate<sup>7</sup> for advice to CESR asking for technical advice on a range of questions.

In August 2007, CESR published its advice<sup>8</sup> (dated July 2007) in response to that mandate. The response was prepared on the basis of a public consultation, summarised in a feedback statement<sup>9</sup> accompanying the advice.

The conclusions of the advice, and the respective questions, are reproduced in **Annex 2**. The main conclusions were as follows:

- CESR has not identified an evident market failure in respect of market transparency on bond markets. Wholesale participants generally seem content with the way in which the cash bond markets currently operate and their level of access to transparency information.
- Access to transparency information for smaller participants, including retail investors, is not as great, and such participants are less likely to be able to make use of information flowing from associated derivatives markets to aid their investment decisions.
- CESR believes there would be value to such users in receiving access to greater trading transparency. Greater transparency might also encourage higher levels of retail participation in the markets – although CESR would argue that various other factors, including the structure of the bond markets, retail investors' understanding of them and the distribution channels used, also play an important role in determining the level of retail involvement.
- Given this, CESR believes any increase in transparency would need to be carefully tailored to ensure that liquidity provision and levels of competition were not damaged as a result of dealers reducing or withdrawing their commitment to the markets. In other words, a thorough cost-benefit analysis should be undertaken by the Commission before any regulatory action.

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<sup>7</sup> [http://ec.europa.eu/internal\\_market/securities/docs/isd/cesr\\_mandate\\_11-06\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/isd/cesr_mandate_11-06_en.pdf)

<sup>8</sup> <http://www.cesr.eu/index.php?docid=4708>

<sup>9</sup> <http://www.cesr.eu/index.php?docid=4709>

### 2.3. European Securities Markets Expert Group (ESME)'s advice

In November 2007, the Commission services also issued a mandate<sup>10</sup> for advice to ESME<sup>11</sup> asking for technical advice on a range of questions.

In August 2007, the Commission services published ESME's advice<sup>12</sup> in response to that mandate. The response was prepared on the basis of a public consultation, summarised in a feedback statement<sup>13</sup> accompanying the advice.

The key conclusions of the advice, and the respective questions, are reproduced in **Annex 3**. The principal conclusions were as follows:

- There does not appear to be convincing evidence of market failure with respect to market transparency in wholesale bond markets by reference to any of the criteria identified, namely wide dispersion of market prices, concentrated market share, persistent excess profits, or investor complaints.
- As regards retail bond markets, all ESME members were agreed that there appears to be some evidence of sub-optimality with respect to market transparency in retail bond markets, particularly in the case of post-trade information relating to corporate bonds. Some ESME members felt that there could even be possible signs of market failure with respect to market transparency in retail bond markets. In the view of ESME members, the most appropriate way to address these retail issues would be through a market-led solution to provide end of day prices in retail sizes in the most liquid bonds.
- In their feedback statement the Commission noted that some respondents had suggested alternative approaches toward transparency that moved away from the usual concept of price and volume transparency. ESME notes that these measures do not appear to have been proposed in response to a market failure. ESME would caution against any mandatory measures to increase transparency in the absence of clear market failure. There would also seem to be some problematic aspects associated with each of the proposals.

### 2.4. Self-regulatory efforts underway

ESME has described self-regulatory efforts underway in these terms:

There has been much debate in the industry in response to the Commission's call for evidence and there have been moves, led by the [International Capital Markets Association] ICMA and the Securities Industry and Financial Markets Association (SIFMA), proposing that the industry take the initiative and consider ways in which more information could be provided to investors without risking the on-going participation of dealers in the market. ICMA have recently conducted a survey across their membership in the UK and the EU to gather their views on the current level of transparency in the European bond markets and whether the ICMA should propose an industry-led initiative to deliver more transparency to the market. (The results of the survey are available on ICMA's and CESR's

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<sup>10</sup> [http://ec.europa.eu/internal\\_market/securities/docs/isd/esme\\_mandate\\_11-06\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/isd/esme_mandate_11-06_en.pdf)

<sup>11</sup> For background information on ESME see [http://ec.europa.eu/internal\\_market/securities/esme/index\\_en.htm](http://ec.europa.eu/internal_market/securities/esme/index_en.htm).

<sup>12</sup> <http://www.cesr.eu/index.php?docid=4708>

<sup>13</sup> <http://www.cesr.eu/index.php?docid=4709>

websites.) ICMA have subsequently formed a Bond Market Transparency working group to assess the feedback from the questionnaires and consider proposals for future developments. ESME understands that ICMA will bring forward proposals in the autumn. SIFMA is also proposing to extend its current US retail focused website ('investinbonds.com') to adapt it to the European Market. The goal of the EU website will be to offer educational services and price information to investors. SIFMA members have approved the proposals and SIFMA is taking forward the development. In addition, ESME members are aware of other initiatives which may also lead to more information being made available to market participants. These are all approaches that ESME supports. As discussed further in the response to Question 6, ESME also believes there is firm evidence that market-led initiatives can respond to bond market inefficiencies both effectively and efficiently. As noted in paragraph 68, ESME recognises that regulators may wish to review the progress of such initiatives after an appropriate period.

## **2.5. The United States experience (TRACE)**

The U.S. corporate bond markets have experienced mandated post-trade transparency for some time under a NASD (now the Financial Industry Regulatory Authority) initiative called TRACE (Transaction Reporting and Compliance Engine). As ESME note,

As regards traded volumes, a number of academic studies<sup>14</sup> conclude that the introduction of TRACE, the Trade Reporting and Compliance Engine introduced by the NASD to facilitate the mandatory reporting of OTC transactions in corporate bonds in the US, has had a positive effect in increasing market efficiency and reducing transaction costs. However, The Bond Market Association's ("TBMA") Response to the Commission's call for Evidence comments that the principal academic research on the effect of TRACE on the US corporate bond market does not analyse in any detail the effect of post-trade price dissemination on liquidity as defined by traded volumes and that most of the studies define and measure liquidity by bid-ask spreads, rather than trading volumes.<sup>26.15</sup>

## **3. NEXT STEPS**

The Commission will take the results of the public hearing into account in finalising its draft report, which is planned to be published in October this year for a consultation period ending in December. Adoption of the report and transmission to the other institutions is now expected to take place in Q1 2008. A revised timetable is set out in **Annex 4**.

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<sup>14</sup> [renumbered ESME footnote:] Bessembinder, Maxwell and Venkataraman (2005); Edwards, Harris and Piwowar (2005); and Goldstein, Hotchkiss and Sirri (2006). Note that other academic studies, notably, European High Yield Bonds by Bruno Biais and Fany Declerk, March 2007, conclude that spreads in European high yield markets compare favourably with those in the US even after the introduction of TRACE and that the difference between investment grade spreads and high yield spreads in Europe is lower than in the US.

<sup>15</sup> [renumbered ESME footnote:] The Bond Market Association (now SIFMA): Response to European Commission's Call for Evidence on price transparency in non-equity markets, 2006.

## Annex 1

### Public hearing, 11 September 2007

#### Agenda

Time	Item	Duration	Speakers
9.00	<b>Coffee and registration</b>	30 mins	
9.30	1. Welcome/housekeeping	10 mins	David Wright <b>Director, DG Internal Market and Services</b> <b>European Commission</b>
9.35	2. European Parliament perspective	20 mins	Mme. Pervenche Berès <b>Member of the European Parliament and Chair, ECON Committee</b>
9.55	3. European Central Bank (ECB) perspective	15 mins	José Manuel González-Páramo <b>Member of the Executive Board, ECB</b>
10.15	4. Committee of European Securities Regulators (CESR) presentation of its advice	15 mins	Eddy Wymeersch <b>Chairman, CESR</b>
10.30	5. European Securities Markets Expert Group (ESME) presentation of its advice	15 mins	John Holland <b>UBS and Chair, Sub-group on non-equities markets transparency</b>
10.45	6. Presentation of key points of Commission background paper	15 mins	David Wright <b>Director, DG Internal Market and Services</b> <b>European Commission</b>
11.00	<b>Coffee break</b>	15 mins	
11.15	7. The consumer perspective	30 mins	Tanya Verrier <b>Expert Forum of Financial Services Users (FIN-USE)</b>
11.45	8. Possible self-regulatory changes <ul style="list-style-type: none"> <li>• ICMA's self-regulatory agenda</li> <li>• SIFMA Europe</li> </ul>	30 mins	Richard Britton <b>International Capital Markets Association (ICMA)</b>  Bertrand Huet <b>Securities Industry and Financial Markets Association (SIFMA)</b>
12.15	9. The academic perspective	45 mins	Mario Nava (Chair) <b>Head of Unit, DG Internal Market and Services</b> <b>European Commission</b>  Prof. John Board <b>University of Reading</b>  Prof. Fany Declerck <b>University of Toulouse</b>

Time	Item	Duration	Speakers
			A/Prof. Norman Schürhoff <b>University of Lausanne</b>
13.00	<b>Lunch break</b>	60 mins	
14.00	10. SEC, NASD and SIFMA Panel - the US debate	45 mins	Angela Knight (Chair) <b>British Bankers' Association (BBA)</b>  Michael Decker <b>Senior Managing Director and Head of Research, Securities Industry and Financial Markets Association (SIFMA), Washington</b>  Doug Shulman <b>Vice Chairman, Financial Industry Regulatory Authority (FINRA) (formerly NASD)</b>  Dr Erik R. Sirri <b>Director, Division of Markets Regulation, Securities Exchange Commission (SEC)</b>
14.45	11. Regulators' panel	45 mins	Samantha Barrass (Chair) <b>London Investment Banking Association (LIBA)</b>  Hubert Reynier <b>Managing Director, Autorité des Marchés Financiers (AMF)</b>  Claudio Salini <b>Head of Markets Division, Commissione Nazionale per le Società e la Borsa (CONSOB)</b>  Hector Sants <b>CEO, Financial Services Authority (FSA)</b>
15.30	<b>Coffee break</b>	15 mins	
15.45	12. Industry panel	45 mins	Norma Cohen (Chair) <b>Financial Times</b>  Olivier Lefèbvre <b>NYSE Euronext</b>  Jane Lowe <b>Investment Management Association (IMA)</b>  Bertrand de Mazières, <b>Director General of Finances, EIB, and new Chairman of AMTE (Euro Debt Markets Association)</b>  Michael Ridley <b>Global Co-Head of Debt Capital</b>

Time	Item	Duration	Speakers
			<b>Markets &amp; Syndicate JP Morgan</b>
16.30	13. Chairman's summing-up	15 mins	David Wright <b>Director, DG Internal Market and Services European Commission</b>
16.45	<b>Close</b>		

## Annex 2

### Conclusions of CESR's technical advice

***Q1: Does CESR consider there to be convincing evidence of a market failure with respect to market transparency in any of the instrument markets under review?***

29. CESR has not identified an evident market failure in respect of market transparency on bond markets. Wholesale participants generally seem content with the way in which the cash bond markets currently operate and their level of access to transparency information.

Access to transparency information for smaller participants, including retail investors, is not as great, and such participants are less likely to be able to make use of information flowing from associated derivatives markets to aid their investment decisions.

With that in mind, CESR believes there would be value to such users in receiving access to greater trading transparency. Greater transparency might also encourage higher levels of retail participation in the markets – although CESR would argue that various other factors, including the structure of the bond markets, retail investors' understanding of them and the distribution channels used, also play an important role in determining the level of retail involvement.

Given this, CESR believes any increase in transparency would need to be carefully tailored to ensure that liquidity provision and levels of competition were not damaged as a result of dealers reducing or withdrawing their commitment to the markets. In other words – and as highlighted by many of the responses to CESR's consultation, a thorough cost-benefit analysis should be undertaken by the Commission before any regulatory action.

***Q2: What evidence is there that mandatory pre- or post-trade transparency would mitigate such a market failure?***

36. Bond and equity markets clearly differ, and increasing transparency in bond markets may not have the same effect on price formation and liquidity as in equity markets. Any transparency regime for bond markets should not be designed with reference to the equivalent regime for equities but, as already discussed, with the aim of addressing any identified failure in the markets under examination.

Based on the responses to the consultation CESR notes that those participants dominating total trading in bonds do not perceive a market failure, and do not feel that greater transparency should be mandated. CESR accepts that action should not be taken which might harm the operation of the bond markets but notes also that direct retail investors, where they exist, would tend to benefit from an increase in transparency. Transparency levels have increased over time as the markets have developed. But whilst this is deemed sufficient by many participants, it evidently fails at present to meet the needs of these retail investors.

37. With this in mind, CESR observes the following: although there is no evident market failure to be corrected, re-distribution of current transparency information could be useful to help retail participants, but this should occur only if the associated benefits would outweigh the costs to market participants as a whole (e.g. in terms of liquidity provision). Before proposing any regulatory action, the Commission should undertake a thorough cost benefit analysis. This cost-benefit analysis will differ according to whether pre- or post-trade requirements are considered; any consideration of a transparency regime should have regard to the existing transparency obligations in place and to the ongoing evolution of market-led transparency (discussed in greater depth in Section 8).

***Q3: To what extent can the implementation of MiFID be expected to change this picture?***

48. The implementation of MiFID will undoubtedly serve to improve retail investor protection in the bond markets. The best execution requirements will assist retail investors in obtaining fair executions, and the broader measures will help to ensure that retail investors for whom bonds are not a suitable investment are not exposed to the associated risks.

49. CESR is also of the view that harmonising the regulatory requirements for the operators of regulated markets and MTFs will probably result in an increase in transparency provision by trading venues. This should assist intermediaries in obtaining trading information, thereby helping them to deliver best execution to their clients. Nevertheless, it is important to recall that the majority of trading in most bonds occurs away from regulated markets and MTFs. The availability of further transparency might be of value, particularly for smaller intermediaries that are less well-placed to access existing transparency sources.

50. CESR believes also that efforts to promote investor education are an important component in helping retail participants understand and manage the risks associated with the bond markets. We are pleased to note the increasing efforts of the industry to provide educational resources to retail investors.

***Q4: Can CESR indicate and describe a significant case or category of cases where investor protection has been significantly compromised as a result of a lack of mandatory transparency?***

55. CESR recognises that problems have arisen in the bond markets occasionally and that, in some instances, these have resulted in significant losses for retail investors. However, CESR is of the opinion that these losses were not the result of, nor could have primarily been prevented by, greater market transparency.

***Q5: Could it be feasible and/or desirable to consider extending mandatory transparency only to certain segments of the market or certain types of investors?***

59. In principle, CESR considers that, subject to careful design, various segmentations could be done. Difference between pre and post-trade transparency is widely recognised. And, clearly, to target transparency towards those participants that currently lack information would seem a sensible proposition. Categorisation linked to trading characteristics could however be more difficult. On the one hand there might be benefits if, for instance, the levels of transparency currently provided across Europe in each segment of the bond markets were harmonised – which is not the case at present. This might benefit investment managers, who would find useful guideposts for pricing the assets they manage, but also those retail and professional investors who do not necessarily have easy access to such information. Once published, the information would allow these same investors to make a more accurate assessment of the quality of order execution they have received; it would also provide intermediaries with a useful frame of reference for establishing their order execution policies and, where necessary, for demonstrating that they have fulfilled their best execution obligations. On the other hand this kind of segregation should be flexible enough to recognise the different needs of each segment and avoid interfering with the markets structure and evolution.

60. As a further consideration, CESR believes that a transparency regime that differentiated requirements based on the type of product may result into artificial effects e.g. some intermediaries systematically deciding to sell certain products to investors compared to others that are not subject to the same level of transparency. This is because, by selling such bonds, these intermediaries may find it easier to ensure they meet the MiFID investor protection obligations discussed above.

61. Nevertheless, any possible EU-harmonised post-trade transparency obligations would need to take account of the risks borne by firms that execute orders for their own account or trade as principals to provide the market with immediate liquidity. The approach used for equities to address the need to protect risk trades may prove relevant in this respect. The technical costs of such an approach might be

alleviated given much bond trading information is centralised by professional associations that play a self regulatory role vis-à-vis their members.

***Q6: What criteria does CESR recommend should be applied by the Commission in determining whether self-regulatory solutions are adequate to address any of the issues above?***

71. Evidently, there is a range of criteria that would need to be taken into account in assessing whether an industry-led solution might be adequate. Notably, however, these factors do not differ materially from those that would have to be considered as part of developing a regulatory solution. In other words, the issue is perhaps more one of who is best placed to deliver the right solution. The fact that transparency – of various sorts and across many markets – is delivered every day by the industry might suggest that any effort to enhance transparency provision in the secondary bond markets was better led by those markets than by regulators. Indeed, the industry may be particularly well-placed to deliver a solution for markets that, by their nature, are cross-border/multi-jurisdictional. However, if the industry were asked to deliver greater transparency, it would have to demonstrate a clear commitment to doing so; otherwise, it might undermine regulators' confidence in the industry's ability to deliver solutions of its own. The progress of such initiatives should be monitored and their impact analysed. The retail participation on bond market might warrant for wider consideration than just transparency. The forthcoming Commission work on retail financial services could be a possibility for such evaluation.

## Annex 3

### Conclusions of ESME's advice

***Q1: 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?***

39. In light of the matters considered above and the papers reviewed in the process of producing this report, there does not appear to be convincing evidence of market failure with respect to market transparency in wholesale bond markets by reference to any of the criteria identified, namely wide dispersion of market prices, concentrated market share, persistent excess profits, or investor complaints.

As regards retail bond markets, all ESME members were agreed that there appears to be some evidence of sub-optimality with respect to market transparency in retail bond markets, particularly in the case of post-trade information relating to corporate bonds. Some ESME members felt that there could even be possible signs of market failure with respect to market transparency in retail bond markets. For the reasons discussed further in the responses to Questions 2, 4 and 6, in the view of ESME members, the most appropriate way to address these retail issues would be through a market-led solution to provide end of day prices in retail sizes in the most liquid bonds.

***Q2: What evidence is there that mandatory pre- or post-trade transparency would mitigate such a market failure?***

40. Key public authorities appear to be increasingly cognisant of the fact that regulatory intervention is only justified where there is evidence to suggest both that the market is failing in some way and that regulatory intervention is the appropriate means to address this failure. For example, Charlie McCreevy, European Commissioner for Internal Market and Services, recently noted that:

“Regulators should only step in when needed. Only when absolutely necessary. Only when there is market failure. Only when the benefits of action unambiguously outweigh the costs. We call this better regulation. This is a misnomer. It is smart regulation.” (Source: Charles McCreevy speech at Finance Dublin 8th Annual Conference, 26 March 2007)

41. The FSA expressed similar views in the conclusion to its Feedback Statement 06/4 setting out FSA's evaluation of the evidence and key conclusions following its survey on trading transparency in the UK secondary bond markets: “We think great care should be taken where regulation impacts, or might impact, on the structures that a market has developed. While mandatory post-trade transparency might raise fewer concerns than pre-trade transparency about the affect on market structure, we are not convinced that regulation in this area would necessarily deliver net benefits, given the possible trade-off in many bond markets between transparency and liquidity provision.” (page 26)

42. This is an approach that ESME strongly supports. The full consequences of regulatory intervention cannot be known in advance and may have unintended, detrimental effects on their liquidity or efficient functioning. This is particularly the case in complex, heterogeneous markets, such as the cash bond market in a multi-jurisdictional region such as Europe (see further paragraphs 1 - 2 of Appendix I for a description of the heterogeneous nature of the cash bond market). The concept of ‘net’ benefit is key in this regard. Mandatory requirements forcing markets in a particular direction are not merited without substantial evidence of two key elements: (1) market failure, and (2) that regulatory prescription is the correct means to remedy the deficiency, such that the cost of the intervention will result in an overall gain to the market. (As has been noted, a high level summary of the main points in favour of and against increasing the level of transparency in bond markets is set out in Appendix I, Annex A.)

43. Even if some form of market failure does exist, public authorities should consider the costs of substantial changes to a market's infrastructure and operation before proposing intervention. These costs are not simply the direct financial costs of implementation but also the impact that change may have on the market and consequently on investors. It is extremely difficult to estimate with any accuracy or confidence either the indirect cost of the change or the value of the benefit that may follow. One of the key arguments frequently posed against the imposition of transparency obligations is that it would deter dealers from providing liquidity. As is explained further in paragraphs 4 - 5 of Appendix I, bond markets are essentially dealer markets with investment banks committing their own capital and providing liquidity to facilitate trading. If dealers feel that their ability to trade out of the large positions they have taken on will be compromised because of increased transparency requirements, they may be unwilling to provide this liquidity and withdraw from the market. A number of the reports reviewed in preparing this response have cited this as a concern in the evidence they evaluate.

44. To address the concern that liquidity may be withdrawn due to increased transparency,<sup>29</sup> before mandating increased transparency it should first be considered how reduced liquidity would impact the ability of investors to trade in the size they want at the speed they require. Would the net effect of such measures actually have a negative impact on the quality of the market? Moreover, what is the gain that may follow from mandating transparency? US academic research on TRACE<sup>30</sup> suggests that spreads would tighten, though the question remains how such effects can be known or quantified in advance.

45. It should also be considered whether the case for intervention in terms of evidence of market failure has actually been made. Many of the authors of the reports reviewed in preparing this report explicitly commented that they did not see convincing evidence of market failure in European markets.<sup>31</sup> Others set out arguments in favour of increased transparency but fell short of attempting to consider the costs and benefits of mandating transparency.<sup>32</sup> ESME agrees that many of the arguments in support of increased transparency have merit and we do not disagree that investors would probably benefit from having more information available to them, particularly with regard to post-trade transparency. However, we do not consider that the fact that benefits could follow from increased transparency is sufficient to conclude that there is convincing evidence of market failure warranting mandatory transparency. This is particularly the case when all the potential consequences of such intervention cannot be known, and when market-led solutions may be able to be developed to remedy any suboptimality, at least in part (see further below).

46. We also note similar feedback given to CESR in response to their call for evidence in March this year. The vast majority of respondents explicitly stated that they did not believe there was any evidence of market failure. Many from across both the dealers and investor communities also expressed the view that any measures to enforce transparency on the market may have unintended consequences of actually reducing liquidity in the market and damaging the efficiency of the market.<sup>33</sup> Similarly, most respondents to the Commission's call for evidence on bond markets opposed the introduction of mandatory transparency obligations because greater transparency would undermine liquidity in bond markets, which are largely OTC, and would threaten their continued development.<sup>34</sup>

47. Finally, it should be considered that any benefits that may follow from mandatory enhanced transparency may be obtained at much lower cost and without mandatory intervention and its associated risk of unintended consequences. Matters have not stood still since the Commission was first tasked with reviewing the possible extension of MiFID's transparency provisions to other classes of instrument in 2004. Market-led initiatives have clearly emerged over the intervening period that have themselves led to developments in bond market transparency.<sup>35</sup> As discussed further in paragraphs 23 - 28 of Appendix I, the emergence of new electronic methods of trading bonds (both through both dealers' own systems and multilateral trading systems), the development of price testing services in relation to valuations, and the recent growth in the CDS market all indicate that market forces are driving increasing transparency in some sectors of the bond markets (though notably not in the more illiquid or higher risk products). The evidence of market led initiatives, such as iTraxx and

Markit (discussed further in paragraph 67 below), in resolving bond market inefficiencies both effectively and efficiently should also be taken into account. Such trends militate against regulatory intervention in the form of mandatory transparency requirements.

***Q3: To what extent can the implementation of MiFID be expected to change this picture?***

*Best execution*

49. Best execution obligations have traditionally largely been the preserve of equity markets. However, MIFID clarifies that the scope of the best execution extends to “all financial instruments”,<sup>36</sup> encompassing fixed income markets.

50. The likelihood is that, while most dealer-intermediary bond market activity will fall outside the scope of best execution,<sup>37</sup> the vast majority if not all trades with retail clients will attract best execution obligations. However, the obligation to the retail client rests with the intermediary that is providing the service to the investor. That intermediary will be required to take “all reasonable steps” to obtain the best possible result for his client when executing a client order relating to a bond. In bond markets, it is likely that those steps will necessitate the intermediary surveying a number of dealers before deciding where it is in the best interests of his client for him to trade.

51. As discussed in paragraphs 9 - 1112 above, there is a large volume of information available to intermediaries ahead of any decision to deal so as to facilitate their being able to comply with these best execution obligations. If there are concerns about the “best buy” lists in some intermediaries where the bonds are listed at par regardless of the market price, these are arguably concerns about whether the intermediary is meeting its own obligations to act in the best interests of its client. In such circumstances, the intermediary will know the prices at which it can buy (or has bought) those bonds and it should be obliged to ensure that the prices it sells them onto the retail investor are reasonably aligned to the market price taking into account its own costs.

52. The provision of more close-of-day trade information about prices in retail sizes in the most liquid bonds to retail investors may help them verify and/or challenge the prices at which they dealt (although this does not absolve the intermediary of its overriding responsibility to deal with the client fairly). Close of day information on bond prices in retail markets may enable retail investors to police this obligation effectively (to the extent they choose to do so), although this information is unlikely to be of much value in illiquid markets where a bond may go for weeks or months without being traded. Given the concerns which have been expressed regarding the potentially detrimental effects of increased transparency (see paragraph 43 above), there would not seem to be a case for an increase in other forms of price transparency on these grounds.

*Suitability*

53. As discussed in paragraph 30, MiFID introduces a new “suitability” regime which will impose obligations on investment firms to ensure that the investment advice they give to their investors is suitable for them. Firms will be obliged to take into account the financial position and the knowledge and experience of their retail investor and his investment objectives in making investment recommendations. These requirements will mean that investment firms must ensure the recommendations they make to investors are suitable in the light of those investors’ needs and financial profile. MiFID’s suitability regime should address some of the risks of investor harm associated with unsophisticated investors investing in the “riskier” end of the bond market. However, it should be noted that even the suitability regime has some limitations in this area, given that bonds are non-complex products under MiFID which can be sold execution-only. Further, the suitability regime would not prevent the type of harm in the event of unforeseen corporate defaults as described in paragraph 28 above, since such bonds would not have been ‘risky’ or unsuitable investments at the time of purchase.

***Q4: Could it be feasible and/or desirable to consider extending mandatory transparency only to certain segments of the market or certain types of investors?***

54. As noted in paragraph 39 above, while there does not appear to be evidence of market failure with respect to market transparency in wholesale bond markets, there appears to be some evidence of suboptimality with respect to market transparency in retail bond markets. (As noted above, some ESME members felt that there could even be possible signs of market failure with respect to market transparency in retail bond markets.) Some increase in post-trade transparency may lead to some overall benefit to the market in two main areas, namely:

- retail investor protection and evidencing best execution; and
- improving portfolio valuations.

*Retail investor protection and evidencing of best execution obligations*

55. As has been noted above, European bond retail investors may benefit from the provision of more post-trade data to verify the execution quality they obtain. Since post-trade transparency can take various forms, the question then arises whether real-time information would be significantly more helpful to retail investors than close-of-day information about average prices, high-low trading ranges and, perhaps, aggregated information about traded volumes? In the view of ESME members, it does not appear that there would be significant additional benefit to retail investors from the provision of real-time information, but ESME considers that retail investors could benefit from some close-of-day information in retail sizes in the most liquid bonds for the reasons discussed. In any event, even if it could be shown that real-time information was somehow more valuable to retail investors than close of day information, this raises the further question of whether this additional benefit would be worth the potential cost of providing that information. The concerns raised as to the potentially detrimental effects on liquidity arising from increased transparency have been noted above.

56. As regards professional investors, this report concludes above that there would not appear to be convincing evidence of market failure in relation to bond market transparency. There is considerable pre-trade information available to professional investors enabling them to satisfy themselves as regards the prices at which they execute and provision of real-time post-trade data would not in the view of ESME members provide any further support to professional investors. The arguments in favour of extending some form of additional transparency to retail investors would not therefore appear to extend to the professional segment of the market.

*Portfolio valuation*

57. The other main area where this report found arguments in favour of increased post-trade transparency was in relation to assisting the provision of reliable information for portfolio valuations, although ESME does not conclude that there is convincing evidence of market failure in this regard. The question again arises as to what form such post-trade information should take to aid the ability of, in particular, smaller managers to value their positions reliably. ESME does not consider that real-time or near real-time information is necessary in this regard and it is likely that close-of-day information about prices and, potentially, delayed information about volumes would be sufficient, not least given the concerns raised as to the potentially detrimental effects of increased transparency noted above.

*How should such increased transparency be effected?*

58. In terms of the manner in which investors could be given more post-trade transparency there are three broad options:

58.1. Do nothing and let the market develop. Paragraphs 23 - 28 of Appendix I outline some of the material market developments in the major bond markets over the last few years. A key theme running

through many of these changes is the increase in electronic trading and consequent increase in availability of pre-trade information to investors. All financial markets, bond markets included, continue to develop with new contracts and methods of trading all generally leading to more openness and availability of information. Much of this is driven by investor demand and also by dealer initiatives looking to capture increased trading flow. There are therefore sound arguments in favour of allowing market forces to dictate what information is made available.

58.2. Regulatory action requiring more information to be published, either in the form of MiFID equity-style transparency requirements or less intrusive but still mandated requirements. ESME does not consider that the introduction of MiFID equity-style transparency requirements is merited in the bond markets. For the reasons discussed in paragraphs 3 - 14 of Appendix I, there are fundamental differences in the structure of bond markets and equity markets - from the manner in which the securities are traded to the nature and investment objectives of the investors. These militate against simply applying a transparency regime which has in essence been designed for equities to the bond markets. This leaves the question of whether some other form of mandatory requirement should be explored. However, given the concerns highlighted above as to the unintended, potentially detrimental consequences of mandated transparency (see response to Question 2 above), ESME's clear preference is for the authorities to work with the market as discussed in option three, rather than prescribe mandatory requirements either on the market as a whole or in selective areas.

***Q5. 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***

***c) increased transparency of effective margins and increased periodic reporting obligations relating to securitized derivatives***

***d) other suggestions***

59. In their feedback statement<sup>40</sup> the Commission noted that some respondents had suggested alternative approaches toward transparency that moved away from the usual concept of price and volume transparency. As an initial point, ESME would note that these measures do not appear to have been proposed in response to a market failure. For the reasons cited in the response to Question 2, ESME would caution against any mandatory measures to increase transparency in the absence of clear market failure. There would also seem to be some problematic aspects associated with each of the proposals below.

***a) transparency of aggregate net risk positions on the part of particular trading venues or market participants***

60. One suggestion was that market participants should be forced to disclose their aggregate positions in various fixed income securities in a similar way to which they are obliged to disclose large positions in individual equities. The disclosure thresholds for equities were harmonised in the Transparency Directive and, broadly speaking, investors holding more than a set percentage of a listed company's shares are obliged to notify the company via a disclosure to the market. The driving principle behind the disclosure obligations is one of control and ensuring that a company knows who its major shareholders are, though it has the added benefit of providing transparency to the market about who owns those positions.

61. ESME considers that it would be difficult to impose similar obligations on bond market investors. Bond holdings rarely convey any right of control over the issuer (ignoring any rights they have should

a company want to change the terms of the issue or seek a waiver of any covenants). Such proposal would introduce a significant amount of complexity over what thresholds were applied and the benefits that would flow to investors are unclear. Further, the concerns expressed<sup>42</sup> by dealers that increased transparency will impact liquidity negatively would be magnified if there was no anonymity about who held the position (since the relatively limited liquidity in most corporate bond investments would mean it would be possible for other firms to guess with some accuracy what trades they had executed, even if the trades were disclosed anonymously).

***b) transparency of overall market activity***

62. The ability to determine the overall level of market activity in equity markets arises because of the detailed, trade-by-trade transparency obligations on market users. There are no additional relevant disclosure obligations. The concerns regarding the imposition of real-time or close to real-time post-trade transparency obligations and their impact on liquidity have been noted elsewhere in this report. However, even if the only obligations were to give periodic, anonymised disclosure of overall volumes, the benefit of any periodic disclosure of overall market to investors remains unclear. This is hard to quantify because the benefits that would potentially flow from increased investors and liquidity need to be balanced against the potential loss of liquidity from market providers.

***c) increased transparency of effective margins and increased periodic reporting obligations relating to securitized derivatives***

63. We understand that this question arose out of a response to the Commission's Call for Evidence from Bundesverband Investment und Asset Management. Margins can refer to a number of concepts, such as a profit margin or the variation and initial margin paid on in respect of derivative contracts, and it was unclear from the response what the BVI were referring to. If the latter then, in the view of ESME, it is difficult to see how the disclosure of such information would benefit investors in the bond markets under review. If the BVI was referring to profit margins and the spread built into structured notes developed by investment firms, ESME considers that the discussion of whether profitability in individual contracts should be disclosed is much broader than the pre- and post-trade transparency discussions. In general, firms are under no obligation to disclose the profit and loss they may make on individual transactions and it is hard to see how they could be forced to do so in certain contracts. The BVI also commented on disclosure obligations with respect to structured bonds and it is worth noting that the Commercial Mortgage Securities Association (Europe) have recently issued guidance on how the disclosure obligations in the Market Abuse Directive should be applied in such markets.

***d) other suggestions***

64. This report and Appendix I allude to the diversity of characteristics within bond markets which makes it debatable how to apply transparency to these products. To address this issue, one ESME member has suggested a framework for establishing an industry-wide transparency rating for non-equities issues. The suggested framework would involve applying certain levels of pre and post-trade transparency, ranging from full transparency to no transparency, upon issue and to existing issues based on certain variables (namely the size of the market, frequency of trading, participant types in the market, credit ratings of the issues, trading methodology, potential effects of disclosure on the liquidity to the marketplace and whether the product is listed or OTC). This is another industry or market-led solution which could be explored through trade associations.

***Q6. Does ESME support moves toward establishing a self-regulatory solution to issues of:***

***a) retail access to information about bond market transparency; and***

***b) the need for better information about overall market activity?***

***a) retail access to information about bond market transparency***

65. ESME would support moves towards establishing a self-regulatory solution in the form of an industry or market-led solution to issues of retail access to information about bond market transparency. ESME supports the approach taken in the initiatives from SIFMA and ICMA discussed in paragraph 58.3. 66. A further important consideration is that a solution which the market is allowed to develop should avoid the unintended and unforeseeable detrimental effects on bond market transparency which may follow from regulators prescribing mandatory requirements. (See response to Question 2 above.)

67. There is also strong evidence that market led initiatives can respond to bond market inefficiencies both effectively and efficiently. The development of CDS indices and, in particular, the various iTraxx indices is one example. As the use of CDS contracts increased it became clear that the market as a whole would benefit from standardised reference data. The market was able to work together to establish the rules for the indices that now form the accepted reference data for many that facilitated certainty about pricing. Similarly, Markit, iBoxx and RED database cash-settlement auctions for CDS after credit events are all examples of market-led solutions successfully resolving market inefficiencies in terms of transparency or otherwise.<sup>43</sup> The STEP (short term European paper) market is another example of an increasingly successful and integrated market where a co-ordination failure was resolved by market participants (with Euribor EBF and the Euribor market with the ECB/Eurosystem acting as the catalyst). Similarly, Indexco, International Index Company, a retail-focused website publishing data on indices and underlying bonds that are part of FX, credit derivatives and bond indices is another example of an industry-led initiative.

68. These initiatives demonstrate that co-ordination among market players can effectively resolve inefficiencies in bond markets. The fact that the market can both recognise and respond to such suboptimalities also weighs against the imposition of mandatory provisions in relation to transparency which may have unforeseen and unintended detrimental effects on bond market structures. However, in recognising the value of such market-led solutions, regulators may feel the need to make clear to the market that they will monitor the development and effects of such initiatives as a means of fostering industry collaboration and solutions.

***b) the need for better information about overall market activity?***

69. As regards an industry or market-led solution to ensure better information about overall market activity, there is no convincing evidence of market failure in this regard and, as discussed in the response to Question 5(c), in the view of ESME's members there do not appear to be convincing arguments in favour of increased information about overall market activity in terms of investor benefit or otherwise.

70. As has been noted, ESME would however see merits in market-led initiatives aimed at providing empirical evidence on the positive and negative impacts on the European bond markets of enhanced trading transparency. A possible way to address this task would be through a marketled pilot project or a controlled experiment, where enhanced trading transparency is pursued, checked and reviewed in a flexible and controlled manner. In this regard, the purpose of flexibility is better served by a market-led initiative. This exercise could be performed for a limited set of financial instruments and under conservative parameters (e.g. proper choice of liquid instruments and publication delays).

## Annex 4

### Key milestones (revised)

Key milestone	Due/ release date
Public hearing in Brussels	11 September 2007
Draft report	October 2007
Consultation period on draft report ends	December 2007
Final report	Q1 2008