Public hearing on non-equities markets transparency,

Brussels, 11 September 2007

Summary of discussion

N.b. for further details of sessions please refer to the materials available at the Commission's website: http://ec.europa.eu/internal_market/securities/isd/mifid_reports_en.htm. Not all comments/questions from the floor are noted here.

1. Welcome/housekeeping

David Wright, European Commission, DG Internal Market and Services

Mr Wright welcomed the delegates and the distinguished speakers and foreshadowed to some extent the day's proceedings. He adverted to the current instability in credit markets, saying while the Commission wanted to hear speakers' thoughts of the relevance of the debate to this topic, it should not dominate proceedings.

2. European Parliament perspective

Pervenche Berès - Member of the European Parliament and Chair, ECON Committee

Mme Berès commented that there could never be 'too much transparency' in financial markets. An absence of market failure was not a sufficient argument in the present context to oppose mandatory transparency rules for non-equities markets. With respect to the instability in credit markets, the focus was on the regulation of credit rating agencies, as well as the scope of the Market Abuse Directive. MiFID would be a step in the right direction in this regard, but any future action should be at EU level. Supervision was also crucial to the issue.

3. European Central Bank (ECB) perspective

José Manuel González-Páramo - Member of the Executive Board, ECB

Dr González-Páramo pointed out that the debate on liquidity vs transparency is US-driven because there are no relevant statistics for the EU. He said it might be risky to transpose the US experience to European markets. There was no evidence that limited market transparency has caused any market failure. There should be a controlled experiment / pilot project to allow the study of the possible effects on liquidity of increased transparency in an orderly way. Market-led self-regulatory initiatives were in principle preferable, but regulation might be necessary if those fail.

4. Committee of European Securities Regulators (CESR) presentation of its advice

Eddy Wymeersch - Chairman, CESR

Prof. Wymeersch stated that CESR had concluded there is no evidence of a market failure in wholesale fixed income markets. While there could be improvements in the re-distribution of price information presently available only to wholesale, CESR preferred self-regulation to address the question, possibly following the clearing and settlement Code example. MiFID should be evaluated first, then other solutions could be envisaged – the new best execution rules should change the situation in any event, at least for retail investors.

Prof. Wymeersch pointed out another issue of concern as the clearing backlog in these markets (c.f. equities clearing backlog of the 1970s).

On credit rating agencies, he stated that the ratings used are the same for government bonds and structured products and queried whether this was justified.

5. European Securities Markets Expert Group (ESME) presentation of its advice

John Holland - UBS and Chair, Sub-group on non-equities markets transparency

ESME agreed with CESR on the state of the wholesale bond markets. However, ESME had concluded there was sub-optimality as to retail access to bond prices; some members of ESME had considered there were possible signs of a market failure. A well-designed market-let solution would be the best way to tackle this. In ESME's view, it was important that any market-led initiative be driven and focussed by what the Commission wants.

6. Presentation of key points of Commission background paper

David Wright – European Commission (DG Internal Market and Services)

Mr Wright set out briefly the contents of the Commission's background paper, which referred, in the main, to the work of CESR, ESME and the US TRACE experience, dealt with elsewhere in these minutes.

7. The consumer perspective

Tanya Verrier - Expert Forum of Financial Services Users (FIN-USE)

Ms Verrier stated that transparency provides investor protection and contributes to the smooth functioning of the market. There was evidence of a transparency deficiency in secondary markets. There had been insufficient research on retail bond markets in Europe. From the point of view of investors, equities and bonds were not fundamentally different (contrary to arguments from industry). Bonds were an investment alternative and they were more complex, therefore financial education is very important. TRACE showed there need not be any trade-off between transparency and liquidity. It was difficult to see how printing retail sized-trades could possibly affect liquidity. Improved transparency would increase retail participation and investor protection. MiFID-like transparency (post-trade) would be the most appropriate solution. Multiple transparency regimes for different instrument types would not be appropriate.

Comment from floor

A representative of corporate issuers commented that the Prospectus Directive's exemption for issuance with a minimum denomination of €50K or higher has contributed to the drying-up of the retail bond interest in the UK.

8. Possible self-regulatory changes

Richard Britton - International Capital Markets Association (ICMA)

Mr Britton set out the ICMA's proposed self-regulatory standard for the publication of price information on an end-of-day basis. This had been developed after ICMA had polled its members in April 2007. Two thirds of the respondents were in favour of a retail-focused project to improve retail access to bond market prices.

The ICMA's self-regulatory standards provide for affected dealers to print, on an end-of-day basis, price and quote information on some 1700 – 2000 of the most liquid bonds. The price information would relate only to trades between €15K and €1M in size to avoid the identification of dealers' large positions by competitors. ICMA would make the TRAX system available as a method for its members to meet the self-regulatory standard.

ICMA's system was planned to be up and running by January 2008, free of charge to retail investors (otherwise members would be expected to make their prices available at no greater than a reasonable cost). There would be a review in 2009 of the impact of the changes. It was expected that there would be minimal, if any, impact on liquidity.

As far as the credit instability was concerned, Mr Britton said that a large part of the picture was reckless lending, poor risk management and mispricing of risk. Price transparency itself was not particularly relevant.

Bertrand Huet – Securities Industry and Financial Markets Association (SIFMA)

Mr Huet outlined SIFMA's proposed Investing in bonds website. This would contain a wealth of information on bonds prices and on bonds themselves, targeted at three separate categories of retail investor. It was proposed to make the website available in 5 languages. The website is being developed by the Bond Market Foundation for SIFMA. One of SIFMA's objectives is to encourage retirement savings.

As far as bond prices were concerned, it was intended to make end of day price indications available. Discussions were ongoing with a number of providers.

With respect to the instability in credit markets, Mr Huet referred to a recent speech by Michel Prada, chairman of the French financial regulators the AMF. In this speech, Mr Prada had referred to a number of forms of price transparency, but had not mentioned price transparency as lacking.

9. The academic perspective

Mario Nava (Chair) - Head of Unit, DG Internal Market and Services, European Commission

Prof. Fany Declerck - University of Toulouse

Prof. Declerck presented evidence that, while TRACE had induced spreads to decrease in the US, effective spreads were still lower in the EU bond markets than the US bond markets. In EU bond markets in 2003-2005, it took more than one week for market prices to fully reflect the informational content of trades. This was solely due to a lack of post-trade transparency.

Qualitative work suggested that EU bond markets are more competitive than both US and UK markets.

Prof. Declerck advocated for a controlled experiment to establish which of the various trade-offs between liquidity and transparency (which were well-understood, but ambiguous) would be dominant.

She also mentioned that the proposals from ICMA, which would exclude professional-sized trades, would exclude the very trades from the transparent space which had the most information content.

Prof. John Board - ICMA Centre, University of Reading

Professor Board discussed the equity markets transparency debate in the UK in the early 1990s. He mentioned that many of the arguments currently being made against mandatory transparency in bond markets were those that had been used with regards to equity market transparency in the past. Transparency in equity markets had narrowed spreads and increased volumes, and had not led to a ‘flight from London’, although some firms had had to make markets in different ways. But possible problems relating to liquidity had been dealt with in equity markets through the block trading regime.

While demonstrated market failure is an important policy tool, it was permissible for regulators to gently push markets in certain directions; there should be a predisposition to more transparency – whether market-led or regulatory. On the liquidity debate, Prof. Board said that possible market participants were never heard from – e.g. those who might originate debt-related consumer products.

On the information content of trades, Prof. Board stated that in equities, the biggest trades are information-free (crossings at a mid-market price), while the information-rich trades were closer to the middle of the size distribution.

He also commented that if a policy objective is to increase retail participation in bond markets, more price transparency would help.

A/Prof. Norman Schürhoff - University of Lausanne

Prof. Schürhoff stated that there was already enough evidence on post-trade transparency from the TRACE studiees in the U.S. TRACE works very well, and a controlled experiment on EU bonds would be very desirable.

Comment from floor

A representative of an investment bank stated that retail investors do buy bonds – in the form of 5-year fixed-term deposit accounts. These are illiquid and not transparent. The average retail investor buys to hold, due to the relative importance of trading costs. The TRACE studies ignore other possible causes for the decline in spreads: e.g. the introduction of pre-trade transparency by trading platforms.

Prof. Schürhoff responded by asking why retail trading costs were so high? The TRACE studies had controlled for other factors in showing a decrease in spreads for the transparent bonds in each rating class.

10. SEC, NASD and SIFMA Panel – The US Debate

Angela Knight (Chair) - British Bankers’ Association (BBA)

Mrs Knight began by outlining the BBA’s perspective, which is to agree with CESR that there is no market failure to be addressed. The new suitability rules deriving from MiFID would go a long way to protecting retail investors.

Doug Shulman - Vice Chairman, National Association of Securities Dealers (US) (NASD)

Mr Shulman described the introduction and results of the Transaction Reports and Compliance Engine (TRACE), announced in 1998 and started in 2002. TRACE had been rolled out gradually in a controlled manner and been subject to rigorous academic studies which had been able to look at transparent and non-transparent baskets of bonds in the same credit ratings.

TRACE had been started by the then NASD at the behest of the then-Chairman of the SEC, Arthur Levitt. Industry's immediate reaction had been negative: there was no retail bond market, and the bond market was unique. In fact, TRACE had uncovered that at least half of trade tickets were of retail size (less than $100K), and 20% of issues trade every day. TRACE prices are used as a factor by all traders now. There are some 35,000 registered users of TRACE.

There was no empirical evidence of damage to liquidity, although there was still anecdotal evidence. The total number of dealers has remained relatively stable. The percentage of institutional-size trades that are bigger than $25M has increased both in high-yield and investment-grade sectors. FINRA would continue to monitor for damage to liquidity. Institutional size trades (>100 million) are still occurring and increasing constantly. 17 interest rate rises within the relevant period as well as technological innovation also no doubt helped alongside the introduction of TRACE.

Marketwatch.com, a recently-established website, is a conduit through which retail investors can get access to pricing data.

Erik R. Sirri - Director, Division of Markets Regulation, Securities Exchange Commission (SEC)

Dr Sirri set out a number of possible policy reasons[1] for increasing transparency in a market. He also stated that both transparency and opaqueness have costs, but they fall on different market participants. Transparency costs fall on large dealers, while opaqueness costs fall on small dealers and on investors. In equity markets, policymakers have been willing to impose transparency and the costs it brings. The rise of ATSs attested to the costs of transparency. In the end, transparency was a question of allocating property rights in the information contained in an order away from the counterparties to third parties. In theory, even the names of the parties could be made public property if policy rationales so required.

Michael Decker - Senior Managing Director and Head of Research, Securities Industry and Financial Markets Association (SIFMA), Washington

- [1] To increase liquidity / decrease speeds
- Increase appearances of level playing field
- render fraud less likely
- Improve execution quality for uninformed investors
- Make it easier for such investors to free-ride
- Better pricing of thinly traded instruments
- Facilitate monitoring of best execution
- Lower cost of capital
- Facilitate supervision in general

Mr Decker asserted that while liquidity is a goal, mandated transparency in US is too blunt an instrument. No demonstrable market failure drove TRACE. Retail was still a small slice of holdings (11%) and an even smaller slice of turnover by volume (2 – 3%) not tickets.

Mr Decker criticized the Bessembinder et al.[2] study which showed trading costs decreasing under TRACE on the grounds that it didn't look at trade volume and in any case excluded high yield instruments. Bond volumes had been flat over the past few years, when compared both with equity and also with credit derivatives volumes. FINRA was now threatening further 'TRACE creep' through amendments which would extend its reach even further.

SIFMA had conducted a 'mini-survey' in the distressed credit market conditions of recent days. Most respondents believed TRACE had reduced spreads, but also that it had negatively affected liquidity and dealers' willingness to risk capital. There was now no bid on bonds in distressed times, according to one respondent.

Comment from floor

A representative of the financial services industry in Europe asked whether there was room for complementary opaque and transparent trading platforms.

In response, Dr Sirri said he didn't know the answer to that question. He also commented in response to Mr Decker's talk that volumes had tended to migrate to credit derivatives markets where transaction costs were significantly smaller. But this wasn't because of TRACE since derivatives of non-TRACE securities had also shown explosive growth.

Mr Shulman said his organisation had always resisted making TRACE a retail-trade-only tape. But TRACE did not disclose the size of trades over $5M.

A representative of a central banking institution asked about the choice of real-time vs delayed publication. Mr Shulman responded that TRACE had begun with time delays. Reporting within the current 15-minute deadline was still a major issue for some dealers.

Regulators' Panel

Samantha Barrass (Chair) - London Investment Banking Association (LIBA)

Sally Dewar – Director, Markets, Financial Services Authority (FSA)

Ms Dewar set out the FSA's position as being basically the same as CESR's view. In terms of the pointers of market failure, (wide spreads, informational inefficiencies, low participation, a high level of user complaints), there was little evidence of these in the market. While retail could in theory be given better access, the question was what was the cost and who was best placed to deliver? Harmonisation wasn't the only solution: there might be room for a number of different transparency regimes. Regulators shouldn't necessarily encourage more direct retial participation if indirect participation would lower risk.

Hubert Reynier - Managing Director, Autorité des Marchés Financiers (AMF)

[2] Citation in Mr Decker's slides

Mr Reynier stated that while the AMF supported CESR's paper, it was necessary to review the CESR position because the context has changed. There were some issues which needed to be looked at, in particular whether it was acceptable that there were with segments of the market where there were no prices and hence no activity. Having said that, AMF was hopeful industry would deliver the right tools, as there were other important issues regulators should focus on.

Claudio Salini - Head of Markets Division, Commissione Nazionale per le Società e la Borsa (CONSOB)

Mr Salini spelled out Italy's plans with respect to this segment. Italy was currently consulting on a mandatory system of price transparency based on the MiFID equity provisions. Italy was consulting ahead of the COM conclusions on this topic because of its high level of retail participation: 20,000 bonds were traded OTC in Italy; the retail investor needs to be able to compare prices. Without mandatory transparency, there was a risk of regulatory arbitrage as between Borsa Italiana, TLX and MTS, all of which trade bonds.

On the instability in credit markets, Mr Salini underlined that transparency was not just about prices and volumes. The role of credit rating agencies was fundamental, as was the role of the prospectus.

12. Industry Panel

Norma Cohen (Chair) - Financial Times

Roland Bellegarde – Head of European Cash Equities, NYSE Euronext

Mr Bellegarde commented that spreads reflect opacity. However, fixed income did not behave the same as equities and he didn't consider that the order book model would work for fixed income markets.

In Mr Bellegarde's view, Price transparency would have given speedier information as to the current credit market conditions but would not have prevented the problems developing. Also only position transparency would really address the current market problems in credit markets.

Jane Lowe – Investment Management Association (IMA)

Ms Lowe stated that institutional investors would be concerned if pre-trade provisions applicable to equities were applied to bonds. Ideally they would want more post-trade transparency, but not at the expense of liquidity. The IMA would always support a controlled experiment.

Bertrand de Mazières, Director General of Finances, EIB, and Chairman of AMTE (Euro Debt Markets Association)

Mr de Mazières commented that there was a proliferation of data in the fixed income world and there needed to be some way of aggregating the data. Also marking to market every day was not possible without post-trade transparency. However there were issues around consistency of data, and perhaps stripping out commission from price data as was already the case in equities would be necessary to allow comparability. It was better, all things being equal, to leave change to the market and use regulators to monitor progress. He supported the idea of a controlled experiment. He also suggested that transparency might have meant the current credit conditions would have been observed earlier.

Michael Ridley – Global Co-Head of Debt Capital Markets & Syndicate (JP Morgan)

Mr Ridley stated that he was a strong supporter of the work of SIFMA and ICMA on the self-regulatory front. Retail clearly needed the ability to check prices. However education was critical to empowering investors.

With regards to the credit instability, his personal view was that credit rating agencies had been a bit slow but otherwise they had done a very good job. Many had misinterpreted ratings – AAA was an estimate of default probability, not of price volatility. Liquidity in cash markets had declined and drifted to derivatives markets, but in general this couldn’t be attributed to TRACE. On the other hand, in today’s distressed market conditions, liquidity in TRACE securities had dried up quicker than in non-TRACE securities such as the [U.S.] s. 144A market.

13. Conclusions

David Wright, European Commission, DG Internal Market and Services

Mr Wright thanked all delegates and the distinguished speakers and the team responsible for organising the event. He said the day had been a great success and had set out very clearly the various arguments for and against price transparency in bond markets.

A broad consensus from CESR, ESME and the industry bodies that there was no market failure in wholesale markets but that access by retail to price information on bonds could be improved. He had been impressed by the self-regulatory advances put forward by SIFMA and ICMA. He added that it was also important that data be made available to academics to enable them to study the impacts of any measures taken closely.

He adverted to the differing views of US colleagues on the question of the impact of TRACE on the quality of the US bond markets. Broadly, regulators were favourable, industry far less so, particularly in the current difficult market conditions. He also outlined the contributions from the academic speakers, who had stated that there was no convincing evidence that transparency would harm liquidity.

Lastly, he referred to the important voices of consumers and of those regulators who were moving ahead already with transparency schemes.

The next steps for the Commission were to take stock of the discussion with a view to publishing a draft final report for 2 months’ consultation in October 2007, with the aim of publishing a final report in Q1 2008.