FESE AISBL
Avenue de Cortenbergh, 52 B-1000 Brussels
VAT: BE0878.308.670
Tel.: +32 2 551 01 80 – Fax : +32 2 512 49 05

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Response

to the European Commission's Call for Evidence on

Transparency in Bond Markets and Other Non-equity Markets

I. Introduction

1. The Federation of European Securities Exchanges (FESE) represents operators of the European regulated markets and other market segments, comprising the markets for not only securities, but also financial, energy and commodity derivatives. Established in 1974 as a small forum of stock exchanges in Europe, FESE today has 24 full members representing close to 40 securities exchanges from all the countries of the European Union (EU) and Iceland, Norway, and Switzerland, as well as several corresponding members from other non-EU countries.
2. We support the planned two-stage consultation and methodology as announced in Sections 2.2 and 2.3 of the Call for Evidence (CE), in particular the fact that the industry would get a chance to provide comments both to the Commission and to CESR in later stages of the study. We consider that the expertise of the industry is particularly important in this area as the markets in question are highly specialized and the content of the transparency measures under question which are being introduced in the equities markets is not yet tested in any market in Europe. Furthermore, we believe that the Commission's own better regulation principles demand that any decisions on the extension of the MiFID transparency regime to non-equity instruments should be taken on the basis of proper assessment of the consequences of such a regime; an analysis of the efficacy of that MiFID regime as implemented for equity instruments would be an integral element of such an assessment. We are aware of the time constraints imposed by Article 65 of the Directive. It is for this reason that we urge the Commission to proceed with caution in this area. In view of the delay in the implementation of the Directive and the changes in the deadlines for several reports, we would also urge the Commission to make use of more time to complete its study if possible.
3. As operators of securities and derivatives exchanges, FESE's members provide a significant degree of transparency to their marketplaces. Transparency plays a key role in the integrity of the price formation process, which, whether it takes place on or off exchange, is crucial to the attractiveness of our markets. However, deciding on the question of mandatory transparency requirements is a complex matter which needs to take into account the heterogeneous nature of the various markets and the specific characteristics of each product type and market structure, as well as the users of the markets concerned.

II. Responses to the Commission's Questions

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

4. We agree with the approach to treat each class of instruments separately and to adapt as necessary the provisions foreseen in MiFID. We find this to be a fully justified interpretation of the Commission's mandate based on Level 1.

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

5. Yes, we consider it broadly sufficient, but have the following comments on the scheme proposed:

   - First of all, there is a need to consider transparency for equity derivatives (based on single shares or index) and especially the plain vanilla type. These financial instruments are in certain markets traded frequently by retail investors and have an impact on the pricing of the underlying instrument.
   - We think it would be useful to create a category for index linked bonds and for convertible or exchangeable bonds because the pricing of such instruments will be influenced by additional elements compared to the other cash bonds indicated in your list.
   - An additional item in the cash bond category, such as 'other bonds', might be useful like for the other categories described.
   - We think that a very important category of securities is missing, the derivatives securities such as covered warrants and certificates. It is not logical to take into account derivatives financial instruments not having the form of securities and not the sub category of derivative financial instruments having the securitised form.
   - We do not think that covered bonds should be included in the category of Asset-Backed Securities.

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

6. First of all, we agree with the reasons listed. In addition, in particular with relation to cash bonds, we would include the distinction between wholesale and retail investors as a separate element (bullet point) in the policy rationale entitled "investor protection". Developing Europe's capital markets requires increasing the share of retail investor involvement in the Single Market which in turn requires establishing investor confidence. The objective of establishing a level playing field regarding information is particularly important for retail investors, who do not have access to sophisticated and costly channels of information. Providing sufficient transparency for retail investors is essential to ensuring that execution policies function and are updated with adequate frequency.

7. On the other hand it should be recognised that a differentiation between the retail and wholesale segments may not always be easy to achieve and may not lead to clear policy conclusions. For instance, while retail investors are in a disadvantaged position in terms of access to information, mandatory transparency requirements might not benefit them in all situations because they may not always be in a position to influence or benefit from the market prices of certain non-equity instruments, for example when the instruments are extensively traded by wholesale participants. This again underlines the need for careful analysis linked to each policy rationale.

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

8. While the prioritisation review is broadly justified as set out in paragraph 3.3, the Commission should make every effort to ensure that adequate time is devoted to those products at the bottom of the priority list in order to ensure that inappropriate one-size-fits all requirements are not imposed.

9. We disagree with the proposal of excluding exchange-traded funds (ETFs), warrants and equity derivatives from the scope on an *a priori* basis. These instruments are heavily traded by retail investors, where transparency could be important for investor protection. For ETFs, transparency rules differ greatly from one country to the other. An important part of transactions with these instruments is carried out OTC, with very limited transparency. For these instruments, the potential benefits of mandatory pre- and post-trade transparency should be studied further before making a

decision. By contrast, for warrants we find potential use in assessing only post- trade transparency, which could facilitate best execution check, because pre-trade transparency is achieved by the structure of the product.

> *Question 5: To what extent do you consider there to be:*
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> *a. observable or demonstrable problems with respect to the possible policy rationales for transparency identified above in relation to one or more of the instrument markets under review?*
>
> *b. evidence that mandatory pre- or post-trade transparency would solve any of those problems?*
>
> *Question 6: To what extent could recent and upcoming technological and market developments in relation to the instrument markets under review:*
>
> *a. contribute to a relatively inexpensive extension of mandatory transparency?*
>
> *b. render mandatory transparency unnecessary?*
>
> *Question 7: To what extent are non-equity financial instruments different from equities so that lower levels of mandatory transparency in those markets may be justified?*
>
> *Question 8: What data sources do you consider relevant to the issues you have raised (if appropriate, cross-refer to your answers below)? Would you or your organisation be prepared to produce any relevant data if necessary?*

Question 5:

10. We agree with the analysis being based on a search for possible problems with respect to the possible policy rationales for transparency identified above in relation to one or more of the instrument markets under review. At the same time, we think that maintaining the current level of transparency in those markets where it has delivered demonstrable benefits is necessary to safeguard investor protection, market efficiency, and sound competition. These benefits will help bring about a reliable basis for best execution in an integrated market and foster cross-border trading. Thus, as a general principle, the exchanges need to have the right to keep the current level of (super-equivalent) rules as allowed in MiFID.

11. At the same time, the European Commission services will also need to find the correct balance between the costs to be borne by market participants compared to the value of the additional information available for investors. Proportionality is extremely important in this area.

Question 6:

12. The extremely wide range of instruments that comprise financial instruments under MiFID makes this a difficult question to answer. Instruments under review are traded electronically, by telephone, by open outcry, in dealer markets, on regulated markets or over-the-counter, and are possibly traded on multiple venues with clearing and settlement being through a unique system or through a choice of system. The instruments under review could be standardised or tailor-made. Hence, there is no straightforward answer to the question of whether recent and upcoming technological developments will contribute to a "relatively inexpensive extension of mandatory transparency" in the absence of any unique method of trading. One can hazard the opinion that financial instruments traded solely by electronic means offer greater potential to render mandatory transparency unnecessary.

13. Non-equity financial instruments cover a broad spectrum of instruments, each of which may be traded in a market that has developed with characteristics unique to the instrument and distinctive to its particular users and uses. For credit derivatives, asset-backed securities and ‘other financial instruments’, these features are generally at a level commensurate with the needs for investor protection and market efficiency required by the knowledgeable and experienced wholesale and industrial users and professional funds that are the primary users of the instruments. As highlighted above, for cash bonds it is necessary to consider the distinction between wholesale and retail investors as a separate element (bullet point) in the policy rationale entitled “investor protection”.

14. We consider that the extension of mandatory transparency will in any event be costly. Even if technology provides efficient and fast solutions, IT developments have to be paid. The persons that might benefit from such developments are not always those that will directly bear the costs related the developments to be performed. This requires the European Commission to carry out a very careful analysis of the expected net benefits of its proposals.

15. For instance, many of our Members already offer pre and post trade information on orders sent to them and on transactions done through their trading systems for issues listed on their markets. However, any new requirements imposed in this area will cost these execution venues the IT development in order to comply with these requirements whereas these changes will not bring in any new revenues, unless there is a considerable increase in the volume of trading in the instruments in question.

<u>Question 7:</u>

16. For the differences between equity and non-equity markets, as well as between cash bond and derivative markets, we refer you to our response above. For non equity instruments the knowledge of the product, which is not standard, is also important and requires the availability of a minimum set of information on the issuer and the issue itself. These differences would likely lead to negative consequences if potential mandatory transparency rules designed for equity markets were to be applied without taking their particularities into account. Although the possibly negative effects of inappropriate transparency in non-equity markets could be addressed with measures similar to those applied in equity markets (e.g. the principle of delayed publication of pre- and post-trade transparency for large equity trades). The appropriateness of such safeguards would depend on the specific instrument in question (and in some cases these safeguards may not fully address the problems).

17. Keeping in mind that any damage to the efficiency of Europe’s wholesale markets would lead to a loss in jobs and global competitiveness, any transparency regime would need to be designed very carefully. In general terms and considering the differences between numerous financial instruments and market structures, we find that post-trade transparency is likely to be useful in more cases than pre-trade transparency requirements, which would, a priori, seem to require a more nuanced approach.

18. To come to a conclusion on the appropriateness of transparency rules for any of these markets, we find it very important for the Commission to study the effects of transparency rules already in existence in Europe. This exercise should first of all take stock of the diversity of structures and regimes in Europe, make a distinction between market characteristics (e.g. wholesale vs. retail) and be conducted on a practical basis. Since it would be too complicated to determine a single benchmark across Europe, the study should concentrate on the effects of cases where there is no pre/post-trade transparency and where there is some pre/post-trade transparency. This study should focus on a proper analysis of the impact and consequences of the transparency rules envisaged to be proposed. As with any cost-benefit analysis, the study should carefully measure “how much transparency costs” and “how much it is valued” by the users of the market in question. Finally, it should be on a product-by-product basis and based on concrete and verifiable evidence.

Question 8:

19. FESE's members are ready to provide all data relevant to this inquiry as required.

> *Question 9: Are there academic or institutional papers or ongoing work that should be considered in preparing the Report not included in our bibliography?*
>
> *Question 10: What conclusions do you draw from the existing academic debate and the ongoing work being conducted by interested parties?*
>
> *Question 11: In your view, how applicable is the academic or institutional literature concerning transparency in the cash equities markets to the present discussion?*

Question 10:

20. We first of all draw attention to the IOSCO Paper May 2004 entitled "Transparency of Corporate Bond Markets", which provides useful analysis on what should be considered in the transparency obligations in the corporate bond/government debt securities markets. In the economic literature, views are divided as to the way transparency impacts liquidity, transaction costs or price formation on the bond markets. Some consider that transparency enhances liquidity (Pagano, Roell and Naik), whereas others believe that transparency affects market efficiency (Madhavan, Bloomfield and O'Hara). As for the institutional papers, we note the recent study commissioned by a number of banking sector associations (May 2006, LIBA et al),. This study covers directly two of the five categories of instruments within the scope of the Call for Evidence and reaches a conclusion about the desirability to study further the benefits of post-trade transparency in one specific case and subject to several conditions. Although this study covers only some elements that need to be studied by the Commission in its report over the next year, we find it a useful contribution to the debate.

Question 11:

21. The academic literature is important but not conclusive. For the reasons explained above, we find the latter institutional study to be of some value but not conclusive with respect to the Commission's study of the full range of options to be considered for these markets.

> *Question 12: What similarities, and what differences, are there between US and EU markets that should be borne in mind when seeking to draw inferences from the TRACE experience in the US?*

22. The two markets are indeed very different in important ways: For example, while the US market benefits from a federal but unified legal system, the EU legal context relevant to securities markets is less advanced in its integration. Similarly, the US market structure shows less heterogeneity than the EU markets in the features referred to in our response 6. Moreover, electronic trading is more widespread in the EU than the US. Another important difference is the different role played by self-regulation in these two marketplaces, with the EU exchanges generally having left behind a big portion of their regulatory responsibilities to the competent authorities, and therefore the market structure offering fewer instances of conflicts of interest among market participants. By contrast, organisations such as NASD have a regulatory role which was intricately linked to the initiation of the TRACE system.

23. Finally, any attempt to draw lessons from the (positive or negative) observations with respect to the TRACE experience should take into account the different regulatory practices in the EU, in particular the structured Better Regulation agenda of the EU institutions, which requires a different process to be followed for any similar project in the EU than would have been the case in the US.

Question 13: To the extent that you have identified problems or believe that others might do so, do you agree that only EU-level action would be appropriate in the present case?

Question 14: If you have identified problems or believe that others might do so, to what extent do you consider those problems would disappear as a natural product of market evolution in the short-to-medium term?

Question 13:

24. As a general and important principle, we reiterate that integrated transnational markets require similar rules and level playing field across borders. Thus EU-level action in this case should be taken if the analysis proves the benefits of introducing a transparency regime. On the other hand any EU-level action should duly take into account the differences between market structures and features.

25. Moreover, any EU actions in this area should be consistent with the situation prevailing in the US and in Asia. No action should be taken if it would undermine the competitive position of EU capital markets compared to the US and Asia.

Question 15: In respect of both pre- and post-trade transparency, are the four options the right ones to consider, and in particular should other options be considered?

Question 16: Would you, in light of your answers to the other questions, favor any of the four options in relation to pre- and post-trade transparency (or another option you might propose for consideration) in respect of transactions in any of:

- *cash government bonds;*
- *cash investment-grade corporate bonds;*
- *cash high-yield corporate bonds;*
- *asset-backed securities;*
- *credit default swaps, interest rate swaps and bond futures; or*
- *any other financial instrument you consider relevant?*

Question 15:

26. While we broadly agree with the options considered, these options should not be used in anyway to pre-judge the outcome of the Review - clearly other proposals might emerge during the Review which must be given due consideration.

27. Of these, the option that seems potentially most sensible to us in the case of pre-trade transparency is “MiFID-like transparency” (but not necessarily the same content of Article 27) that is appropriate for the relevant financial instruments and which would ensure a level playing field among execution venues. For post-trade transparency, we would see benefit in rules similar to MiFID Article 28 (along with a regime for delayed publication).

28. However, before coming to a definitive view on which of these options, if any, is appropriate for each market in question, the Commission should carry out its study as described in our response to Question 7. The optimal level of transparency for the financial instruments under review is conditional on a number of complicated factors, not least of which are the requirements of users of and investors in the instruments in question and the efficiency that enhanced transparency might bring to relevant markets.

III. Conclusion:

29. To sum up, the analysis of whether and what type of transparency (both pre- and post-trade) is needed for non equity instruments should be based on empirical assessments of the consequences of transparency, in particular its effects on the efficiency of markets and the confidence of investors in such markets. In order to fully assess these potential effects, it would be necessary to wait for evidence of how MiFID operates in relation to equity markets before deciding whether to extend the transparency regime to non-equity markets. We would then have a benchmark for comparison and could learn from the experiences in relation to the equity markets. This would also be in line with the Commission's White Paper for Financial Services 2005 – 2010 which states that better regulation requires 'evidence-based policy-making' and that there is a need to carefully assess and analyse legal texts to see if they work, modifying or repealing them if that is not the case. In this context, the Commission's proposals in the discussion paper are useful to launch the debate but should not pre-empt the assessment and analysis that is necessary when it comes to consideration of transparency.

30. On the other hand, we recognise that Art 65(1) might not allow the Commission the luxury of time. The appropriate approach should therefore balance the need for prudence to avoid untested measures with the need for potential pre-emptive action justified by clear policy considerations. One Important element of this approach should be differentiating between markets, instruments, and users. For example, the Commission should take into account the OTC nature of the global bond market, the leading role played in it by EU firms and credit institutions, and the market-led development of its trading and transparency. If transparency measures impact liquidity adversely this could lead to higher costs of borrowing for sovereign and corporate debt in the EU. As a general principle valid for both bond and derivative instruments, an evidence-based approach should be taken.

31. We are aware of the diversity of views on this issue - both in favour of no transparency at all and in favour of full transparency. The diversity of views is itself a natural consequence of the heterogeneity of the markets in Europe and signals the importance of a nuanced approach that looks at each product and market carefully. We agree with the Commission's approach which takes into account a range of options, i.e. not just full or no transparency, but also a degree and a structure of transparency that would be tailored to these markets. What is clear at this point in time is that, if we want to introduce transparency into such markets, it would have to be designed carefully, since the provisions of Articles 27 and 28 have been written with equity markets in mind only.

32. As FESE we are ready to provide further input to the Commission for this important study.