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RESPONSE

CESR CALL FOR EVIDENCE ON NON-EQUITIES MARKETS TRANSPARENCY

I. Introduction & Executive Summary:

1. The Federation of European Securities Exchanges (FESE) is a not-for-profit international association (AISBL), representing the operators of the European regulated markets and other market segments, comprising the markets for not only stocks and bonds, 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 EU and Iceland, Norway, and Switzerland, as well as several corresponding members from other non-EU countries.
2. We believe that 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 expected outcome. We are aware of the time constraints imposed by Article 65 of the Directive. It is for this reason that we support the current Call for Evidence and the analysis to be carried out by CESR to provide input to the Commission.
3. As operators of securities and derivatives exchanges, FESE's members provide a high 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 functioning of our markets. Many of our members who have developed regimes for transparency in their respective jurisdictions (e.g., Denmark, France, Germany, Italy, Malta, Norway, Netherlands, Spain, and Sweden) have observed that these regimes have been instrumental in developing markets as well as attracting retail investor participation in their markets. As we prepare to implement MiFID, the scope of which extends to all instruments in most areas (e.g. with respect to best execution), it is important to explore whether transparency measures similar to those conceived for equity instruments may be necessary to achieve the objectives of MiFID in other instruments as well.
4. 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. As the scope of the current Call for Evidence is limited to cash bonds, we will be focussing here on the characteristics of the cash bond markets. While these markets show some similarities across Europe, there are differences, too. Specifically, one needs to keep in mind that there are different levels of transparency depending on the country and, within each country, depending on the specific type of bonds. Retail participation across Europe also shows significant variance. A general point of guidance that can be drawn from the experience of our markets is that, if the intention is to develop retail bond markets, then a degree of mandatory transparency should be considered.
5. We would like to address the question of whether a transparency regime would have an impact on the market structures that exist in Europe today. We believe that this is well possible (although its specific effects would depend on the market and the regime selected). However, we do not interpret this conclusion as a clear sign that a mandatory transparency regime should be avoided. After all, the whole of MiFID is likely to have a major impact on the market structure for equities in many areas. The more important

question in determining whether a transparency regime should be introduced is whether there is a strong potential benefit for the investors or the market as a whole. The fact that a regime of transparency that may be contemplated could have an impact on markets should not be in itself a deterrent for introducing such a regime.

6. As our answers to the questions indicated below demonstrate, we can point to several areas which CESR can study further until delivering its advice to the Commission in June. We would be happy to collaborate with CESR further if further information is required in any of the areas touched below.

II. Detailed Remarks:

1. Does CESR consider there to be convincing evidence of market failure with respect to market transparency in any of the instrument markets under review?

7. In order to be able to answer this question, CESR should reflect on a clear definition of what constitutes a “market failure” in non-equity markets. Broadly speaking, market failure is a term which describes a situation in which markets do not efficiently allocate goods and services, or where market forces do not serve the perceived public interest. Specifically, one would have to search for evidence of a substantive degree of informational asymmetry and demonstrate that the proposed policy would address the asymmetry and result in a positive net gain for the public as a whole.

8. In practical terms, it is very difficult to prove market failure without robust academic research which would have to be conducted for the EU cash bond market in particular. However, CESR could pursue in its further research **several indications** that such a potential market failure might exist in the cash bond market, as follows:

(a) Disparity in the ask/bid prices for fixed income assets:

9. Voluntary transparency as that which exists in bond markets often results in information asymmetries. Due to the existing information asymmetries between market participants insofar as they do not have the same market information or equal access to such information (which may also be received at different times), price differences do occur in practice for transactions on the same fixed-income asset.

(b) Low degree of retail influence in fixed income asset:

10. An additional inefficiency could arise in the fixed income markets: the degree of retail investor participation in these markets is not proportionate to the significance of these investors in equity products, where their participation benefits the market depth, the activity ratios, the correct asset valuation and, in sum, influences the role the market plays in the overall economy.

(c) Lack of global statistics on fixed-income markets:

11. The lack of general information is proven by the absence of databases and global statistics on a European level concerning turnover and prices. Nevertheless, in the experience of our members, the continuous supervision of transactions by market operators on fixed income products of either public or corporate debt can help mitigate the information deficit observed in these instruments.

(d) Lack of market data impairs the functioning of best execution rule:

12. The lack of market data regarding pre- and post-trade transparency renders difficult any monitoring of the implementation of the best execution regime. This includes the assessment of whether best execution was delivered but also the evaluation and updating of best execution policies.

2. What evidence is there that mandatory pre- and post-trade transparency would mitigate such a market failure? & to what extent can the implementation of MiFID be expected to change this picture?

13. With regard to the consequences of MiFID in this area, one can only make predictions, since the Directive will not be implemented before November. One possible effect of MiFID is fragmentation of equity markets. However, the transparency rules for equity markets contained in the directive and implementing measures are intended to counter-balance and mitigate this risk and ensure adequate information for investors in order to maintain fair and orderly markets. Whether the directive has any effect on the fragmentation of markets in non-equity instruments is even harder to say, but it should be noted that the starting level of trading on transparent execution venues in bond markets is significantly lower than in equities Irrespective of whether volumes are presently to be found on transparent venues or not, the increase in the possible number of venues for execution of client orders will mean that firms will need to have access to data that shows which venues are delivering best execution for all instruments to which this obligation applies.
14. Secondly, although the transparency measures introduced by MiFID in the equities area have yet to be implemented, many of our members have experience with transparency regimes which function well and help build retail investor confidence and improve the access of retail investors to their markets.
15. Finally, some direct empirical evidence on the effects of transparency on bond markets can be obtained from studies made on the US market, as the introduction of the Trade Reporting and Compliance Engine (TRACE) by NASD in July 2002 provides a possible testing ground with real market data. The conclusions of several studies of these effects demonstrate the following benefits of increased transparency in bond markets:
    - Increased transparency results in a decrease in trading costs in a range between 20- 50% depending on the study and the size of the sampled trades.[1]
    - Greater transparency increases liquidity in bond markets (measured both by trading volume and bid ask spread) as a result of the abovementioned lower transaction costs and a reduction of information asymmetries thus benefiting less sophisticated investors.
    - Increased transparency results in intensified competition among dealers and boosts market innovation (as demonstrated by the appearance of new fixed income products and structures linked to transparency measures).
    - Increased transparency benefits are far from being a “zero sum game”. It is true that such benefits are of greater benefit to liquid bonds but this does not come at the expense of illiquid ones, as the latter, albeit to a lesser extent, also profit from it .

[1]Edwards, Nimalendran and Piwowar (2006); Edwards, Nimalendran and Piwowar (2005); Bessembinder, Maxwell and Ventarataman (2005).

16. However, lessons from the US experience with the TRACE system may not be easily applicable to the EU bond markets, since in contrast to the US, the European bond market is dominated by government bonds, whereas the share of corporate bond issues is relatively small.

3. To what extent can the implementation of MiFID be expected to change this picture?

17. The biggest impact of MiFID in this area will be with regard to the application of the best execution principle in a multi-venue environment. A case could be made that it is very difficult for MiFID best execution provisions to be met in the absence of a comprehensive transparency obligations regime for such instruments, because of two factors:
    - Insufficient pre-trade transparency would impair a price-based decision on where to send a bond order; and
    - Insufficient post-trade transparency would make the selection of trading venues and the revision of its best execution performance based on price impossible.
18. In sum, investment firms would find it difficult to include price among its best execution factors when designing their best execution policies for bonds. According to MiFID, price is a factor that has to be considered in any execution policy and, what is more important, price is compulsorily the main criterion for best execution policies addressed to retail investors (as a major component of the "total consideration" of costs borne by the retail investor). This is confirmed by CESR's recent consultation document on Best Execution (February 2007 - 07-050b).
19. We note that it has been argued that the transaction reporting regime set in MiFID may introduce some degree of transparency into the market and alleviate some of the problems described above. We disagree with this line of argument since MiFID reports on transactions are not disseminated to the market but directed exclusively to the competent authorities. Furthermore, they have nothing to do with immediate or real time transparency as they may be reported up to the close of the following working day in which the transaction took place.

4. 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?

20. Whilst in the case of institutional investors the impact of transparency requires further study, there are clear signs that the lack of transparency might lead to operational inefficiencies and distortions in the pricing of fixed income products in the case of retail investors. This in turn suppresses the activity volume of this type of investor in European markets. Retail investor protection and participation could be improved by pre- and post-trade transparency that increases their access to information. Moreover, such measures could be helpful even for professional clients, who in fact demonstrate a great degree of diversity in terms of access to information and level of sophistication across Europe. While the primary benefit of transparency on prices would be to improve the delivery and monitoring of best execution to retail clients, such benefits could also extend to some categories of professional clients for which the total consideration of the execution of a transaction will be the most important factor.

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

21. In responding to this question, it is certainly worthwhile considering the experience of MiFID, which is based on the general principle of mandatory transparency to all market segments and investors and incorporates a design which includes a rather sophisticated degree of differentiation among different types of investors, market segments and instrument types. The equities regime thus has concepts such a SMS, liquid shares, delays for disclosure etc, all of which are aimed at calibrating the pre- and post-trade transparency requirements to specific types of transactions and products. We do not mean to assume that the equity regime as designed in the relevant articles would function equally well for bond markets, but the basic principles of differentiation could apply to bond markets as well.

6. 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?

22. As a matter of principle, FESE advocates self-regulatory approaches wherever possible. However, we find self-regulation generally more suitable to situations where there is no prior regulation; by contrast, the issue under study relates to the extension of existing requirements, potentially modified, that arise from an existing, comprehensive regulatory framework. Therefore the combination of regulatory and self-regulatory approaches in one single area may be more complicated and difficult.
23. Having said that, it is important to be clear about the conditions under which such an approach would be more suitable than a formalistic (mandatory) approach. Therefore, the Commission's question to CESR is a very important one.
24. In general terms, we believe that the **factors below** (some of which are inter-linked) can be used to assess whether a mandatory or self-regulatory approach should be preferred:
    - ⇨ **Whether investor protection is a paramount policy objective**: Where investor protection is a key goal, a mandatory approach should be preferred.
    - ⇨ **Risk of market failure and the nature of the market:** Where the market is a predominantly dominated by professional players and the risk of market failure is low, a self-regulatory approach would seem to suffice.
    - ⇨ **The degree of harmonization required:** Where the degree to which the basic principles have to be harmonized is high, a self-regulatory approach would not be sufficient.
    - ⇨ **The likelihood of agreement across a full spectrum of market participants**: A self-regulatory regime would seem to require that it be designed and coordinated by a wide spectrum of market participants and not just one segment of the market, and monitored in an objective and transparent fashion. Where inherent differences of interests among market players exist, a self-regulatory approach cannot be implemented in line with these conditions.
    - ⇨ **Consistency and level playing field:** Where several elements of a market are already the subject of a mandatory regime, such as MIFID, a self-regulatory approach may not yield the necessary level of consistency and level playing field across market participants engaged in different types of instruments and market segments.

III. Conclusion:

25. FESE members share an interest in maintaining efficient, transparent and attractive marketplaces that are able to attract a broad range of investors. Many of our members have developed regimes for transparency in their respective jurisdictions and have observed that these regimes were instrumental in attracting retail investor participation in their markets. This experience should be taken into account when studying the potential benefits and feasibility of transparency requirements for bond markets.

26. Since further research is necessary to make a decision on whether a mandatory transparency regime for European bond markets is justified at this point, we urge CESR to study in particular the following factors which indicate that a market failure could exist in these markets:

    - Disparity in the ask/bid prices for fixed income assets:
    - Low degree of retail investment in fixed income asset:
    - Lack of global statistics on fixed-income markets.

27. Once the need for more transparency is established, CESR will need to establish an opinion on what kind of impact a potential policy measure would have in relation to the market failure potentially identified. An important fact to take into account is that the increase in the possible number of venues for execution of client orders after MiFID implementation will mean that firms will need to have access to data that shows which venues are delivering best execution for all instruments to which this obligation applies. The biggest impact of MiFID in this area will be with regard to the application of the best execution principle in a multi-venue environment. It might be very difficult for MiFID best execution provisions to be met in the absence of a comprehensive transparency obligations regime for such instruments.

28. In addition to the study of existing transparency regimes in Europe and the impact of MiFID, CESR could also draw some conclusions from the studies carried out on the US market which look at the impact of the introduction of the Trade Reporting and Compliance Engine (TRACE) by NASD in July 2002. The conclusions of several studies of these effects demonstrate that transparency could lead to a decrease in trading costs, increase in liquidity as a result of lower transaction costs and a reduction of information asymmetries, and intensified competition among dealers and a boost for market innovation.

29. The focus of this study should be the impact of transparency regimes on retail investor protection and participation. Moreover, such measures could be helpful even for professional clients, who in fact demonstrate a great degree of diversity in terms of access to information and level of sophistication across Europe. Increasing the level of transparency would help assess best execution achieved primarily for retail clients but be of use for certain categories of professional clients as well.

30. Another important feature of a future transparency regime is whether differentiation by market/investor segment would be possible. Such differentiation appears fully feasible in light of the experience of MiFID, which is based on a design which includes a rather sophisticated degree of differentiation among different types of investors, market segments and instrument types. Although the equity regime as designed in the relevant articles may not function equally well for bond markets, the basic principles of differentiation could apply to cash bond markets as well. In this regard, if the transparency regime is found to affect the existing market structures, we feel that this would not be a sufficient argument against transparency as long as it is justified on the basis of net benefits for investors or the market as a whole.

31. Finally, we appreciate the opportunity to provide views on the criteria that should be applied in choosing between mandatory transparency as opposed to self-regulatory initiatives. The key criteria in our view include:

    - Whether investor protection is a paramount policy objective;
    - Risk of market failure and the nature of the market;
    - The degree of harmonization required;
    - The likelihood of agreement across a full spectrum of market participants; and
    - Consistency and level playing field.

32. Thus, a self-regulatory approach should be preferred only if investor protection is not a paramount objective; there is not a high risk of market failure and the market is generally dominated by professionals; there is no need for a high level of harmonization; the market participants representing all areas are likely to come to an agreement; and there is no substantive concern for consistency with existing rules or a level playing field among players active in different segments of the market.

33. By contrast, where investor protection is a key goal, where the market contains a significant retail segment and the risk of market failure is not negligible, the degree to which the basic principles have to be harmonized is high, where inherent differences of interests among market players exist, and where several elements of a market are already the subject of a mandatory regime, such as MIFID, a self-regulatory approach may not yield the necessary level of consistency and level playing field across market participants engaged in different types of instruments and market segments.