

**ICMA response to CESR Call for Evidence
concerning Non-Equity Market Transparency
6 March 2007**

ICMA is pleased to respond to this call for evidence and we look forward to the opportunity to respond further to the consultation paper that we understand CESR will issue in due course. We note the request not to repeat points made in our previous submission to the Commission last September and we have endeavoured not to do so.

We also note, however, that the Commission has drawn attention to the comments of ICMA and a number of trade associations on possible market-led changes to enhance bond market transparency, and that CESR has specifically been asked to inform itself of what is being planned.

To assist CESR in that regard we therefore refer to the Discussion Paper (DP) we published on 15 February, 2007 (a copy of which was supplied by ICMA to CESR on the same date) in which we seek the views of ICMA members and other market participants on proposed pilot services for enhancing post-trade transparency in international debt securities. The DP is available on our website and is being given wide circulation across our membership in order to assess their views on how to proceed.

Notwithstanding our firm conviction that there is no evidence of market failure requiring mandatory regulation, our membership continues to want to constructively engage with European institutions in order to assess where market-led solutions could deliver benefits. We must stress, however, that internal discussion amongst our membership is at a very early stage and that it has yet to be established whether any of the specific proposals will be agreed and implemented,

In the meantime we have answered CESR's specific questions below.

Questions

In framing our response to the questions we have noted that the Commission has framed its questions to CESR in the context of 'cash bond markets', namely cash government and supranational bonds, cash investment grade corporate bonds, and cash high yield corporate bonds. Our comments follow the same approach.

1. 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?

Although the Commission did not refer to market failure in its Call For Evidence it is clear from the responses that most respondents had concluded that there is no evidence of a significant market failure, as they chose to define it, which would call for mandatory intervention. Our discussions with our members certainly reflect the overwhelming majority view that there is no evidence of market failure requiring mandatory intervention.

We also share the majority view that in any consideration of the level of market transparency in European bond markets, full account must be taken of the high level

of commercially driven pre-trade transparency, particularly for sovereign, supranational and investment grade corporate bonds. This pre-trade transparency seems to be growing and is already highly consolidated by vendors such as Bloomberg and Reuters. ICMA suggests that at the very least this mitigates the comparative lack of post-trade transparency.

Furthermore, respondents who favoured enhanced transparency (such as FIN-USE) appeared to base their arguments on the presumption that the retail investors are 'prevented' from participating in bond markets by the difficulty in accessing market information. It is unclear as to what evidence FIN-USE uses to make this claim though it is clear that many retail investors would find the cost of subscribing to the main market data providers to be prohibitive. Indeed FIN-USE repeatedly pointed to the need for more research on retail participation in bond markets before arriving at policy conclusions. It also focuses on the need for better investor education on the nature of bonds and their differences to equities.

ICMA agrees with these latter propositions. We hope that the pilot services we are discussing with market participants and users will, if implemented, help to answer some of the questions about whether access to traded prices will act as an incentive to greater direct retail investor participation. While post-trade information currently available to retail investors is probably sub-optimal we cannot view it as a market failure given the availability of retail bond funds and the range of information on government and other high quality bonds that is available. The retail service proposed by ICMA is designed to partially fill the gap in information available to retail investors and hopefully will encourage greater participation by them.

Although vendor services carrying pre-trade quotes may not be directly accessible by most retail investors because of cost, that should not be a deterrent to banks, brokers and portfolio managers which service retail investors. By observing competitive quotes such intermediaries should be able to inform their retail client as to prices available in the market and provide the best possible result when executing their transactions when dealing in bonds for which there is a reasonable level of investor interest. We comment on the impact of MiFID on this below.

We also note that many respondents to the Commission commented on TRACE in the US. While we acknowledge the increase in market data available through the TRACE system, we are also concerned that volumes in the US corporate market have declined since its introduction while volumes in the European market continue to increase. Some member firms inform us that they have reduced their capital commitment to the US corporate market, and in particular the high yield sector, as a result of TRACE.

2. What evidence is there that mandatory pre- or post-trade transparency would mitigate such market failure?

It is of course difficult to comment on this question as it is dependent on evidencing the proposition that there is a market failure in Europe's cash bond markets as required by Question 1. However, ICMA believes that mandatory transparency is unlikely to be sensitive to the concerns of liquidity providers and indeed may well not even adequately address the needs of retail investors. Indeed, there is sufficiently strong evidence that regulatory intervention intended to protect retail interests can have the opposite effect.

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

ICMA believes that MiFID will bring important benefits to retail investors in cash bond markets. Indeed our presumption is that key elements of MiFID, effectively enforced, will provide greater improvements in retail investor protection than could be achieved by mandatory imposition of greater transparency on the bond markets as a whole. The key elements in that proposition are

- Treating investment advice as a core activity
- The suitability and appropriateness tests
- Conflicts of interest management
- The obligation to obtain the best possible result

We would expect that these requirements, many of which will be new to the regulatory framework of some Member States (at least to the extent that they impose detailed and not generalised obligations on investment firms dealing with the public) will significantly improve the position of retail investors vis a vis issuers and professional investors .

Transparency in bond pricing and trading has the potential to be informative, but can also be misleading unless the recipient has a relatively sophisticated understanding of the factors which influence the price of a bond. One simple example is the willingness of some investors to take on higher levels of risk by purchasing lower rated credits in order to maintain the historical yield on their portfolios. They have not understood that in inflation adjusted terms today's relatively low yields from highly rated credits may give them the same real return as they did several years ago when inflation was higher.

A more complex example concerns the comparison of equity and bond prices. When an investor buys a share, and it goes up in price, the market has validated her judgement. Similarly, if the price falls, the market calls that judgement into doubt. To the investor these facts are obvious. However, when an investor buys a bond the analysis is more complex. If the bond goes up in price, i.e. its yield falls, is that because the market is reassessing the credit positively (and validating the investor's judgement) or is it merely because inflation and/or the yield on the local government bond has fallen? Logically, it is possible for a corporate bond to increase in value in these circumstances even when its credit is deteriorating. To understand precisely what is happening it is necessary to track, not the price or the yield but the spread over the government bond yield. Few retail investors we suggest are sophisticated enough or adequately resourced to do this, although their broker can. This is why we believe that MIFID's role in increasing the quality of investment advice will prove vital.

The role of education is also important and while ICMA cannot by itself adequately educate the world of actual and potential bond investors we hope that the educational element in ICMA's retail web site, if members agree, would be important contributor. We are also encouraged by the increased availability of retail bond market educational material on the sites of ATS in general and ICMA will encourage this kind of development through its membership and other trade associations.

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?

It is ICMA's belief that recent cases in which retail investors have lost money would not have been prevented or mitigated by mandatory transparency for the reasons set out in the description of the factors which affect bond prices as set out in response to Question 3. We know of course that IOSCO raised the proposition in its 2005 report 'Strengthening Capital Markets Against Financial Fraud' in which the Technical Committee noted the allegation in at least one instance, institutional 'insiders' might have been able to sell their bonds to other investors without alerting those investors to possible problems because the public prices of the bonds failed to reflect their sales*.

As far as we are aware this remains an allegation and no cases have been brought which might have substantiated the allegation. In contrast, in the case of Parmalat, it is matter of record that 27 major institutional investors, in the US, lost in excess of \$1.6 billion on the company's default†.

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

ICMA remains opposed as a matter of principle to the imposition of transparency by statutory regulation. As noted above, commercially driven pre-trade transparency is high in some markets and generally rising overall. An ECB paper on transparency and liquidity, published in August 2006, reinforces this view by stating: "There is a higher level of competition in the European bond markets, and this is reflected in the level of pre-trade transparency in wholesale markets, which is greater than in the United States. Indeed, the pre-trade transparency in some liquid market segments is so high that it makes the real-time post-trade transparency for price discovery purposes obsolete". Post-trade transparency is also increasing albeit at a slower pace.

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?

The Commission has taken an evidence-based approach to the issue of transparency in bond markets. We believe that to be appropriate. Therefore, a condition precedent to this question is whether CESR will be able to produce 'evidence' that there is, for example, a market failure and further, that mandatory pre-or post trade transparency would mitigate such a failure while market led solutions would not, or that there has been a significant case where investor protection has been significantly compromised which would have been mitigated by mandatory transparency as opposed to market-led solutions.

ICMA believes that the Commission has, with justification, set a high burden of proof. However, ICMA also believes that it is possible to introduce greater post-trade transparency in a way that will add value to all participants and will not lead to a withdrawal of dealer-provided liquidity. This philosophy underpins our current

* Page 19

† Moody's

consultation with our membership and other market participants. Inevitably, if the system is to be provided on the basis of informed consent of the participants (as we believe to be the only way forward which will not have unexpected and negative consequences) there may be some who will choose to remain outside. Having only a few dealers providing data will not provide investors with a consolidated view of the market. One of the tasks of participants will be to persuade others to join. We would argue that the costs of using mandatory transparency in an attempt to achieve 100% participation would be difficult to justify in terms of benefit to investors even if it were possible, in these days of global capital mobility, to ring-fence European bond trading and prevent it leaking to the outside. In this context it will be illuminating in due course to examine the experience of OTC equity trading under MiFID.