

CNMV Advisory Committee 12/03/07
Consultation on non-equities market transparency
(CESR/07-108)

As part of the new market architecture, MiFID introduces pre- and post-trade transparency requirements for equities. MiFID requires the Commission to report to the European Parliament and the Council on the possible extension of scope of the pre and post-trade transparency obligations to transactions in classes of financial instruments other than shares.

In November 2006, CESR responded to the European Commission's initial request for information in relation to bond markets. At its September 2006 meeting, the CNMV Advisory Committee responded to a public consultation on the subject from the European Commission. In its reply, it advocated establishing a transparency regime for fixed-income and derivatives markets similar to that established by MiFID for equities, but having regard to those markets' peculiarities.

Now the Europe Commission has requested a second phase of technical advice from CESR, focusing on fixed-income markets.

Although some of the questions posed by CESR refer to very specific aspects, in addition to giving specific replies, the CNMV Advisory Committee includes more general comments in which it further elaborates on the arguments set out in its September 2006 reply.

Specifically, the reasoning underlying these replies is based on the idea that **the extension of the transparency requirements to fixed-income markets is connected to the "best execution" requirement imposed by MiFID on fixed-income markets**. The point is also made that, insofar as MiFID's general market model essentially involves moving towards the existing model of fixed-income markets, and "transparency" is considered to be indispensable as a result, there is no reason why the other markets should not be governed by the same principles.

On that basis, the CNMV Advisory Committee's replies to the questions raised by CESR are as follows:

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?

In general, the lack of high transparency standards in markets in fixed-income instruments lead to the following inefficiencies:

- o *Mismatches between prices applied in purchase and sale transactions in fixed-income assets.*

In general, information asymmetries arise in Europe's fixed-income markets between market participants, since not all are party to the same information, the same resources or the same access channels, and information is not received in the same conditions as regards timing. This leads to differences in the prices applied to purchases and sales of the same fixed-income instrument.

o *Low level of retail investment in fixed-income assets*

As a result of the lack of common standards in terms of market information between different investor classes, an additional inefficiency arises in the fixed-income markets: retail investors' participation in this market is negligible compared with the equities market, where their participation contributes to market depth, activity ratios, price discovery and, in the final instance, market efficiency.

o *Lack of overall statistics for fixed-income markets.*

The most evident expression of the general lack of information is the fact that there are no data bases or overall Europe-wide statistics of trading volumes or prices. However, in our experience, where (as in Spain's public and private fixed-income markets) there is monitoring and constant supervision of operations and information on transactions in fixed-income securities, this remedies the dearth of information about these securities.

2) What evidence is there that mandatory pre- and post-trade transparency would mitigate such a market failure?

One example of empirical evidence of the effects of transparency on bond markets can be found in studies on the US market, since the implementation of the *Trade Reporting and Compliance Engine* (TRACE) by NASD in July 2002 provides a unique test-bed with real market information.

Those studies reveal the following benefits of increasing transparency in bond markets:

1. Transaction costs fell by 20%-50%, depending on the study and the size of the transactions being analysed¹.
2. Higher liquidity in the bond market (measured in terms of both trading volume and the bid/offer spread). As a result of the lower transaction costs referred to above and the reduction of information asymmetries, therefore benefiting less sophisticated investors².
3. Greater competition among brokers, which boosts market development and innovation (as evidenced by the appearance of new fixed-income products and structures as a result of transparency requirements)³.
4. Enhancing transparency are not a zero-sum game by any means. Although the benefits are more evident in liquid bonds, this is not at the expense of illiquid bonds, since the latter also benefit, albeit to a lesser extent⁴.

¹ Edwards, Nimalendran and Piwowar (2006); Edwards, Nimalendran and Piwowar (2005); Bessembinder, Maxwell and Venkataraman (2005)

² Goldstein, Hotchkiss and Sirri (2006)

³ Edwards, Nimalendran and Piwowar (2005); Laganá, Perina, Köppen-Mertes and Persaud (2006)

TRACE is essentially a transaction reporting mechanism that disseminates market information with a 45-minute lag. Some of the studies cited above suggest that additional benefits would be gained if the time-lag were shorter or pre-trade transparency rules were introduced.

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

From a theoretical standpoint, it is hard to argue how the best execution principle imposed by MiFID for fixed-income markets can be complied with unless it is accompanied by a system of transparency requirements.

1. The lack of pre-trade transparency hampers brokers' decisions as to where to execute orders.
2. The lack of post-trade transparency makes it impossible to select trading systems, establish best execution policies and review the degree to which this requirement is complied with using price as the criterion.

In short, investment firms will find it difficult to use price as a criterion for best execution when designing policies for fixed-income assets. It is worth emphasising here that, under MiFID, price is a factor that should be considered in setting any best execution policy; in fact, price is the main criterion that must obligatorily be considered in best execution policies aimed at retail clients.

It has been argued that the system of reporting transactions to the supervisor that is envisaged in MiFID would introduce a degree of market transparency which might alleviate some of the aforementioned problems. We consider this argument to be flawed since the reporting system envisaged under MiFID would only distribute trade data to the supervisors, but not to the market.

Moreover, we consider that MiFID seeks to ensure competition between trading systems, a level playing field for competition, efficient price discovery, investor protection, etc. To this end, it establishes various trading systems (Regulated Markets, Multilateral Trading Facilities, Systematic Internalisers) as well as rules of conduct and transparency requirements.

We understand that these principles, which will wreak substantial changes in the current structure of the equities markets by making them more similar to the model existing in the fixed-income markets, should also be applicable to the financial markets as a whole.

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?

Whereas it is hard to find evidence of cases where protection of institutional investors has been compromised due to lack of transparency, since that investor group has

⁴ Edwards, Nimalendran and Piwowar (2005)

access to a high level of information, there may be operating inefficiencies and price distortions for other investors insofar as they have less access to information.

This Advisory Committee considers that CESR members' Complaints Departments are best able to answer this specific question, since this Committee has no information in this connection.

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?

Transparency is an asset in itself that has been achieved by the more developed markets through their improvement processes. High standards of transparency are positive for all market participants: issuers, financial institutions, intermediaries, investors, etc.; in short, they produce more efficient and competitive market environments.

As a general principle, and with the goal of reaping the benefits of a more efficient market, transparency obligations should be imposed on all segments of the bond market and for all classes of investor, which is the principle applied in MiFID for transparency obligations in the equities market.

Nevertheless, the structure, classes of investor and types of trade in the bond market make it advisable to tailor the transparency regime to its peculiarities so as to avoid the potential drawbacks of a one-size-fits-all approach. The transparency regulation provided by MiFID for equities markets recognises similar problems and allows a number of exceptions, limits and lags in reporting based on share liquidity, trade type and the characteristics of the trading system.

Therefore, we believe that extending the transparency requirements should not be based on the type of client performing the trade or on the characteristics of the product but, rather, that a system of exceptions, limits and lags in the reporting obligations should be established that best fits the specific needs of the fixed-income markets.

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 foregoing answers highlight the importance and significance of all aspects of extending the pre- and post-trade transparency requirements to fixed-income markets and products, and the need to attain a system that is coherent with the principles of MiFID.

Any attempt to address these basic aspects (which comprise the architecture pursued by MiFID) by means of self-regulation will inevitably lead to disparate systems, resulting in unequal and inefficient transparency. Therefore, a common legal framework should be developed by the European Commission for all Member States.

Self-regulation may be applicable for transposing EU regulations to national rules, so as to take account of the organisational peculiarities of each market and allow Member States to impose stricter requirements if they wish.