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FESE Response Ref: CESR/10-510**CESR Technical Advice to the European Commission in the context of the MiFID Review****Non-equity markets transparency for Bonds (CESR/10-510)**

I. Introduction

The Federation of European Securities Exchanges (FESE) represents 45 exchanges in equities, bonds, derivatives and commodities through 20 full members from 29 countries, as well as 7 Corresponding Members from European emerging markets. FESE is a keen defender of the Internal Market and many of its members have become multi-jurisdictional exchanges, providing market access across multiple investor communities. FESE represents public Regulated Markets. Regulated Markets provide both institutional and retail investors with transparent and neutral price-formation. Securities admitted to trading on our markets have to comply with stringent initial and ongoing disclosure requirements and accounting and auditing standards imposed by EU laws.

FESE members operate Regulated Markets that offer a transparent and neutral trading infrastructure to trade equities, bonds and derivatives. **The value proposition of exchanges is based on pre and post trade transparency, which is essential to price discovery for the whole market. Exchanges strongly believe that transparency is essential to ensure price discovery. Price transparency is also essential to liquidity because it allows investors to price their risks and to liquidate their positions at all times. Transparency therefore is an essential ingredient of a well-functioning financial market.** A central order book with transparency and neutrality generates sustainable interest in all asset classes, including bonds. Moreover, this principle has been proven right by the financial crisis, during which the OTC bond markets came to a standstill, and investors were unable to find any reliable marketplace. In fact, most OTC bond markets were completely shut down during a part of the crisis.

FESE welcomes the opportunity given by CESR to respond to the Consultation Paper on technical advice to the European Commission in the context of the MiFID review on transparency for bonds.

II. Executive Summary

1. **We agree that there is a need to regulate transparency for bond markets in the context of the upcoming MiFID Review by the European Commission.** FESE responded to the previous consultations held by CESR on the subject of transparency in the non-equities field. We find it fully justified to re-open the question in the context of the financial crisis, which has demonstrated the importance of market structure to liquidity and safety of markets. During the crisis, certain OTC bonds markets have stopped functioning normally, among which cash bond markets, and seem to have been particularly hit by the lack of transparency. This has affected not only retail but also professional investors. There is a need to restore confidence in these markets with long-lasting solutions, of which transparency is one important element. Moreover, in the several years that have passed since MiFID, the self-regulatory approach has not been sufficient. Therefore, FESE fully supports the main conclusions of CESR's report on transparency on corporate bond, structures finance product and credit derivatives markets (Ref. CESR/09-348) approved in July 2009, in which it stated that additional post-trade transparency would be valuable.
2. In our view, **mandatory transparency regimes should be applied to all bond types and not only corporate bonds**; hence, throughout this consultation, we refer to **all fixed income products** (i.e. government bonds, corporate bonds, sovereign bonds, etc). Nonetheless, more complex products such as structured finance products should be looked at in more detail.

3. **We recommend pre- and post-trade transparency for all bonds, whether admitted to trading on a RM/MTF or not.** Currently, the majority of bonds are admitted to trading on a RM, even though the majority are not traded on exchange, but OTC. The fact that bonds tend to be admitted to trading on a RM brings with it many advantages for the investors, because these bonds are issued with initial and ongoing issuer disclosure requirements and are subject to other important investor protections such as conduct of business rules. However, if trading in bonds becomes subject to transparency obligations, but if this is only required for bonds admitted to trading on a RM, this might act as a disincentive to admission to trading on a RM and in the end reduce transparency of all kinds. Thus, it is important to introduce transparency also for instruments not admitted to trading on MiFID regulated venues. Therefore all proposals must be extended to both on-exchange and off-exchange trading of products admitted to trading on a RM or MTF as well as privately placed fixed income instruments (i.e. not admitted to trading on a Regulated Market).
4. **The crisis contains many lessons for bond market policy.** Through the financial crisis, the main reasons that led to sharply reduced liquidity in secondary trading of European corporate bonds were:
- Loss of investor confidence in general
 - Widespread increase in aversion to credit risk
 - Some of the main players disappearing due to banks going under, leading a lack of price contributors
 - De-leveraging process taking funds out of the markets, and
 - Loss of credibility in the credit risk assessors and in the methodologies used.

The lack of information exacerbated all these factors, in particular the loss of investor confidence in general, the increase in aversion to credit risk and the loss of credibility in the credit risk assessors and in the methodologies used. Therefore, we believe that the collapse of corporate bond markets during the crisis indicates **a market failure for transparency in these instruments, particularly in the OTC trading of such instruments.** Mandatory pre- and post-trade transparency should be introduced for bonds. Although there are some current indications of recovery, it is clear that the (already very limited) level of voluntary transparency that existed before the crisis will not recuperate unless there is **mandatory** transparency.

5. **Transparency and liquidity in bond markets do go together.** In this context, there are a number of very positive case studies we would like to bring to your attention:
- In the Maltese market, pre- and post trade transparency for corporate and sovereign bonds is equivalent to that for equities on the Regulated Market. In the OTC, post-trade transparency in respect of bonds is also equivalent to that of equities. Such transparency requirements have been in force since 1992 when the Exchange started operating and were considered to be crucial for investors to gain confidence in the new market. While MiFID requirements covered only equities, it was felt detrimental to back-track on prevalent transparency requirements which extended to all securities traded on the RM and OTC. The Maltese OTC market is already done through the electronic platform which facilitates transparency requirements.

Another example of a well-functioning transparency regime is in Denmark where there has been a post-trade requirement in place for bonds for many years which there is no evidence has a beneficial impact on all the market and its stakeholders. In Denmark, all banks are obliged to publish trades with DK listed bonds within 3 minutes after execution, similar to the MiFID requirement in place for equities. This provides a high level of transparency in Danish bonds for the benefit of all stakeholders, banks, issuers and investors.

Likewise, in order to seek greater protection for retail investors, the Spanish market, AIAF Mercado de Renta Fija, has recently implemented a new electronic trading platform, SEND, with the aim of providing greater pre-trade transparency to fixed income issues distributed to these market participants and admitted to trading on this market

In all these examples, we see that mandated transparency has not been harmful to liquidity; on the contrary, it has boosted liquidity.

6. Beyond transparency, **the structure of the secondary market is also important**. Given the many benefits of electronic trading for the clients and for the market as a whole, **there should be an incentive within MiFID to shift telephone-based OTC trading to electronic platforms**. This is a prerequisite to successfully implementing a pre-trade transparency regime. It is also necessary for a level playing field between OTC and on-exchange (RM or MTF) trading.
7. FESE members think that **there is not enough data in the market to comply with MiFID best execution requirements, which according to MiFID applies to all instruments, including bonds**. Investors need to know how their firms deliver best execution factor by factor (price, costs, speed of execution, likelihood of execution, etc.) While best execution is multi-factor, ie not only about price, access to data on price is an important element of both designing and monitoring best execution policies for bonds. In the current environment, it is impossible for market participants to assess/monitor best execution properly.

III. General access to pre and post-trade information

Q.1: On the basis of your experience, could you please describe the sources of pre- and post-trade information that you use in your regular activity for each of the instruments within the scope of this consultation paper:

- a) corporate bonds
- b) structured finance products (ABS and CDOs)

For bonds, neither pre- nor post-trade data is mandatory. Even if there are certain important differences in the price formation process for equities and bonds, pre-trade and post-trade transparency can play a positive role in enhancing liquidity in fixed income markets as well and would be crucial to ensuring and assessing best execution.

The current lack of market transparency leads to information asymmetries which result in weak investor protection. Improved transparency would lead to lower bid/offer spreads. Investors would benefit both from better prices and a proper implementation of the best execution requirements, for which a certain level of price transparency is necessary.

IV. Corporate Bonds

1. Scope of corporate bonds transparency regime

Q.2: Are there other particular instruments that should be considered as ‘corporate bonds’ for the purpose of future transparency requirements under MiFID?

The limitation of the scope to corporate bonds is too restrictive. We believe that the debate on transparency should not be limited to corporate bonds; it should also cover ALL BONDS, e.g. sovereign bonds, covered bonds, structured products, etc.

Moreover, the scope should not only cover bonds admitted to trading on a RM, but also all other bonds. In other words, any new transparency regime should be imposed on both on-exchange and off-exchange trading of fixed income products admitted to trading on a RM or MTF as well as privately placed fixed income instruments (i.e. not admitted to trading on a Regulated Market), for three reasons:

- The trading of bonds on RMs is already transparent because the RMs provide transparency for all the products they trade, whether there is a MiFID requirement or not; focusing on this segment only would be superfluous and inappropriate;
- By contrast the real need is in bringing more transparency to the OTC trading (telephone brokerage and electronic platforms) of bonds;
- Finally, if the regime for OTC trading is only focused on bonds that have been admitted to trading on RMs and MTFs, then this will serve as a disincentive to be admitted to trading on RMs and MTFs and in the end reduce the amount of transparency in the market and will lead in an unlevel playing field.

Q.3: In your view, would it be more appropriate, in certain circumstances, to consider certain covered bonds as structured finance products rather than corporate bonds for transparency purposes? Please explain your rationale.

First of all, we recommend transparency for both structured finance products and corporate bonds. As to the specific question, no, we do not think that in certain cases covered bonds should be classified as structured finance, especially if the outcome is that they would be outside a transparency regime. Covered bonds should be within the scope of a MiFID transparency regime, irrespective of how they are classified. For example in Denmark, the covered mortgage bonds that are traded on the NASDAQ OMX market are subject to a transparency regime as part of the exchange rules. This works well and there is evidence that covered bonds are suitable for transparency.

2. Pre-trade transparency for corporate bonds

Q.4: On the basis of your experience, have you perceived a lack of pre-trade transparency either in terms of having access to pre-trade information on corporate bonds or in terms of the content of pre-trade transparency information available?

Yes, we have. Bonds are traded overwhelmingly on an OTC basis (composed of e-platforms and voice negotiation). Unlike RMs, which make bond price information available even though it is not mandatory, OTC dealers do not provide any significant degree of pre-trade information to the public without being required to do so by law. In the majority of the countries in Europe, there is no information on the prevalent prices in the OTC. Prices for bonds are therefore not determined by the interaction of supply and demand. It is practically impossible for investors to survey all dealers prior to a trade.

Lack of transparency has several manifestations. There is a lack of historical turnover statistics, ie prices and number of transactions, a general lack of real time information and reliable figures on market shares for bonds.

The lack of information creates information asymmetries, suboptimal executions due to the lack of harmonised reporting/data on prices and a difficulty in applying best execution to bonds. Fragmentation due to dispersed liquidity on various platforms does not allow investors to have a full view on existing liquidity, unless they develop specific sophisticated tools to gather price and size information from these platforms. This functionality is almost impossible to monitor for voice dealing and retail investors.

Overall, the lack of transparency in the bond markets in Europe is a result of the following structural factors:

- Information asymmetries that lead to disparity in the ask/bid prices
In general, voluntary transparency has provoked information asymmetries. Due to that, market participants do not have the same market information and not equal access to information. Transactions on the same fixed-income asset are not received at the same time and prices differ.
- Low degree of retail investment in fixed income asset
As a consequence of the unlevel playing field in terms of market information, the degree of retail investor participation in this market is very small. This fact was used as a justification for not mandating transparency standards during the MiFID negotiations. However, this is a circular argument: It is actually because there is no transparency that retail investors cannot get into this market. But if there was no transparency, retail investors would benefit from direct participation in this market (as argued by the Euroinvestors and Euroshareholder associations).
- Lack of global statistics on fixed-income markets
The lack of general information leads to an absence of databases and global statistics on a European level. Because of the lack of standards, the market cannot digest even the limited amount of transparency that exists.

All of these factors would be addressed by introducing mandatory standards for pre-trade transparency.

Q.5: In your view, do all potential market participants have access to pre-trade transparency information on corporate bonds on equal grounds (for example, retail investors)? Please provide supporting evidence.

No, they don't. FIN-USE in its response ¹ to CESR consultation on MiFID complex and non-complex financial instruments for the purposes of the Directive's Appropriateness Requirements states the following: *"Retail investors need to be much more thoroughly informed and advised about the severe risks they face that are generated by the illiquidity and lack of transparency of these fixed income markets. Every issuer should also disclose clearly and precisely how and where the issue will be listed, how it intends to ensure a minimum liquidity level on the secondary markets if any, who are the market makers for the issue and what are their mandates if any. Also, the retail investor should be clearly informed at the time of subscription of the market price if any of the issue, or of the most comparable one."*

We believe that pre-trade transparency would help not only retail investors but professional investors to achieve best execution in fixed income securities.

Retail investors in particular do not have the same access to pre-trade information as institutional investors because the sources of pre-trade information are usually professional information providers such as Bloomberg and Reuters. Hence, retail investors are usually not able to assess the pricing quality of bonds offered by their intermediary. By contrast, in the equity space where transparency is mandated, there is a range of possible sources of data on transactions executed on RMs, which can be

¹ http://ec.europa.eu/internal_market/fin-use.../mifid_fin_instruments_en.pdf

accessed for free on the RMs' website within a short timeframe (eg 15 minutes), accessed through retail brokers who have access to the RM data as traders or through their trading brokers, or through commercial data vendors. What makes bond data much more difficult to access for retail investors is that the bond data is generally only OTC and this is generally only made available to institutional investors.

In fact, the lack of data affects the deal that a retail investor gets. For example, most retail investors who invest in bonds rely on their banks' or brokers' own OTC offers when they wish to trade bonds. These offers, so-called 'fixed price deals', usually comprise of higher spreads than the bonds traded on an exchange. However, most banks and brokers do not actively offer their customers to trade the bonds on an exchange but rather prefer an OTC deal out of their own inventory (systematic internalisation). Higher pre-trade transparency for retail investors would probably result in better comparability and therefore better prices for retail investors. . Since the most relevant factor for best execution for retail investors is the total determination (i.e. price and costs), the lack of access to data for retail investors significantly undermines the application of the best execution rule to bonds.

Q.6: Is pre-trade transparency efficiently disseminated to market participants? Should pre-trade information be available on a consolidated basis?

No, pre-trade transparency is not efficiently disseminated to market participants. There is currently only limited pre-trade transparency for corporate bonds, only available to select market participants. As already stated, we believe more pre-trade transparency should be introduced. It should be introduced in the same way as it was for shares within the MiFID framework. There may be a need for certain supervisory standards on the reporting of the data – e.g. for the data format to be "easy for processing"- but, as in the equity data field, we strongly believe that there is no need for a mandated consolidated tape.

**Q.7: What are potential benefits and drawbacks of a pre-trade transparency regime for:
a) the wholesale market; and
b) the retail market?**

If you consider that there are drawbacks, please provide suggestions on how these might be mitigated.

A pre-trade transparency regime is beneficial for both wholesale and retail markets. Increased transparency brings competition and innovation to the markets².

We believe that there are only benefits of a pre-trade transparency regime for all investors. These potential benefits include a higher visibility of bid and ask quotes for bonds, better comparability, and therefore more efficient prices. Benefits are creating a level playing field for information access and threshold management. We believe that Regulated Markets are the best solutions.

As previously mentioned, the numerous experiences with transparency in bonds have been very positive with regard to liquidity and investor protection, and have been crucial in stimulating a very active secondary market in corporate bonds.

² Edwards, Nimalendran and Piwowar (2006) "Corporate Bond Market Transparency: Liquidity Concentration, Informational Efficiency, and Competition"; Laganá, Perina, Köppen-Mertes and Persaud (2006) "Implications for Liquidity from Innovation and Transparency in the European Corporate Bond Market"

Q.8: What key components should a pre-trade transparency framework for corporate bonds have? What pre-trade information should be disclosed?

Pre-trade transparency should offer the following:

- Differentiation per product
- Differentiation of small and large caps
- Differentiation per client /trading unit (retail, wholesale)

Pre-trade information should include quotes (bid and ask quote) including the offered size together with a time stamp. The quote should be an indication of the trading price which one can expect when trading a size smaller (or equal) than the quote size.

As a general principle and in order to fully harvest the benefits of increased transparency, we believe that transparency obligations should be imposed on all bond markets segments and investors, following the same principle that MiFID rules apply for all shares.

It has sometimes been argued by others that there transparency may be harmful to less liquid bonds. We disagree. We believe that all asset classes have more and less liquid segments, but the transparency rules should apply to them all as a principle, with the specific obligations being calibrated, where necessary, for less liquid instruments. The MiFID framework for shares transparency acknowledges a similar problem with large trades and allows a number of waivers, thresholds and delays based on the liquidity of the share, the type of the transaction, the size of the transaction and the features of the trading venue.

Therefore we believe that the approach should not be to extend mandatory transparency only to certain market segments or investors, but to require transparency for all bonds and all investors, and to provide for the specific calibration with the use of well-designed waivers, thresholds and delays on transparency obligations where needed for less liquid bonds. Given the experience of equity markets, however, special attention should be given to avoiding any loopholes that would undermine the overall transparency regime.

3. Post-trade transparency for corporate bonds

Q.9: Do you think that notional value would be a meaningful piece of information to be made accessible to market participants? Is there any other information that would be relevant to the market?

Yes, we do.

Q.10: Do you agree with the initial proposal for the calibration of post-trade transparency for corporate bonds? If not, please provide a rationale and an alternative proposal (including supporting analysis).

We welcome CESR's initial proposals for the calibration of a post-trade transparency regime, although we think it should take into account the following considerations:

- The timing proposal "as close to real-time as possible" should be supplemented by adding a maximum delay limit (e.g. 3 minutes).
- For any transaction, size, price and volume information should always be disclosed.
- We think it is important to maintain a deferred disclosure for large in size orders, but also to limit its use to only orders that truly need protection. Delays for timing of publication may depend on assets' liquidity which should be worked on in more detail. In principle, delays should

not be based on nominal thresholds but be made relative to total issue size – possibly taking into consideration the security type. If a nominal value was used, the threshold and the maximum delay would have to be worked out so that it does not lead to excessive delays for the majority of the market.

Q.11: Should other criteria be considered for establishing appropriate post-trade transparency thresholds?

In order to achieve an appropriate post-trade transparency, CESR should consider the following principles:

- **Homogeneity:** There should be common rules for all market participants.
- **Universality:** Transparency should apply to both on-exchange and off-exchange trading for products admitted to trading on a RM as well as OTC instruments.
- **Comprehensiveness:** The regime should cover ALL BOND types.
- **Real time:** Information should be made available as close to real time as possible.
- **Maximum dissemination:** Information should be electronically available.
- **Free access:** Information should be available to all market participants.
- **Industry-led consolidation:** Data from venues should be consolidated in a competitive market environment, through commercial vendors.

Q.12: Given the current structure of the corporate bond market and existing systems, what would be a sensible benchmark for interpreting “as close to real time as possible”?

We think it should be 3 minutes. In today’s market circumstances, if it is possible to report a trade within, for example, 15 minutes, it is also possible to report it within 3 minutes. Except for the cases that justify delayed disclosure, real-time transparency within 3 minutes should apply. This provides a high level of transparency for the benefit of all stakeholders, banks, issuers and investors.

Other remarks

In addition to what we stated on transparency, we would like to comment on market structure, which is also very important for investor protection and quality of markets:

There should be an incentive to shift telephone-based OTC trading to electronic platforms. This is a prerequisite to successfully implementing a pre-trade transparency regime and to generating a level playing field between OTC and on-exchange trading.

Recent events on the Greek sovereign debt have highlighted the limits of the OTC market. In such circumstances, quotes are given as indicative rather than firm and market depth information is lacking on real flows. Voice transacting and/or electronic trading outside RMs and MTFs do not carry established rules or enforce common dealing practices across all market practitioners. The current non-standardization of the trading environment and the lack of common governance between all these venues create market situations often close to typical market failures.