THE COMMITTEE OF EUROPEAN SECURITIES REGULATORS

Ref: CESR/07-284b

CESR´s response to the commission on non-equities transparency

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Section 1: Introduction and CESR's approach to the Commission's questions

1. Article 65, paragraph 1 of the Markets in Financial Services Directive (MiFID) requires the European Commission to report to the European Parliament and the European Council on the possible extension of the scope of the provisions of the Directive concerning pre- and post-trade transparency obligations to transactions in classes of financial instruments other than shares.

2. In June 2006, the Commission published a call for evidence that posed a range of questions relating to possible policy rationales for mandating transparency, whether the work should focus first on cash bonds (and, in particular, on government bonds and corporate investment-grade and high-yield bonds) and broader considerations, such as the nature of the non-equity markets and ongoing developments in technology and transparency provision.

3. The Commission published a feedback statement on 13 November 2006. 59 organisations, representing all principal sectors of the financial markets, responded to the call for evidence, with a number of important points arising:

    - There was opposition of varying degrees to the introduction of mandatory transparency obligations for financial instruments other than shares. Some responses related to significant differences between equities and non-equity financial instruments. Others pointed to the lack of evidence of market failures that would warrant regulatory intervention. And some responses noted the possible adverse impact of a market transparency regime on liquidity in non-equity markets. Several respondents also noted that the functioning of the MiFID transparency regime for shares should be evaluated first, as well as the impact of other MiFID rules such as best execution.

    - There was lower opposition to post-trade transparency than pre-trade, and open-mindedness towards the possibility of considering a tailored solution for retail investors and other market participants who found it harder to gain access to market information.

4. In August 2006, the Commission requested CESR to provide initial assistance on the issue of non-equity market transparency by conducting a fact-finding exercise in relation to cash bond markets. In October 2006, CESR provided its response to that request. CESR's analysis revealed that:

    - There was a lack of comprehensive, harmonised information on the nature and size of EEA bond markets. As a general observation, the information available on government bonds was viewed as more reliable than that available on corporate bonds.

    - Pre- and post-trade transparency requirements in Member States were generally set up for/by regulated markets and, in some cases, multilateral trading facilities (MTFs).

    - There are some common characteristics in bond market users and structures in the EEA, but also some key differences between Member States. Such differences relate, amongst other things, to the level of direct retail involvement in the bond markets.

5. On 27 November 2006, the Commission requested further assistance from CESR with regard to its work under Article 65(1) of MiFID. CESR was asked, as a general point, to react to the evidence in the Commission's feedback statement, with a specific focus on the markets for cash government and supranational bonds, cash investment-grade corporate

bonds and cash high-yield corporate bonds. In addition, the Commission posed a number of specific questions for CESR to consider:

Question 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?

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

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

Question 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?

Question 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?

Question 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?

6. CESR issued a call for evidence on 6 February 2007 asking for views on the Commission's questions. The response period closed on 6 March, and CESR included the key points from the responses in a consultation paper (CP) which was published 9 May 2007. The consultation period which included an open hearing closed on the 8 June 2007. This final advice reflects the comments received. A separate feedback statement describing the comments and CESR´s response in more detail has been published on CESR website [Ref. CESR/07-430].

7. The next section in this document discusses some further background to the issue of non-equity transparency. Sections 3 to 8 address each of the questions in turn. The main part of the paper concludes with a brief summary. The paper also has an annex that sets out existing transparency in the European bond markets.

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Section 2: Background information

8. The transparency regime set up by MiFID for markets in shares admitted to trading on a regulated market takes explicitly into account the fact that the business, mechanics and regulation of regulated markets and MTFs are fundamentally different from those of trade execution by an investment firm. In other words, it promotes the disclosure of as much trade information as possible, allowing for the fact that the same degree of transparency is not suitable for all business models.

9. The differences in financial instruments together with the specific trading needs of market participants are considered key factors to be taken into account when designing a transparency regime for non-equity financial instruments. The responses to the call for evidence appear to indicate that any approach to transparency obligations should start by dealing with the differences between share and cash bond markets, the specific and different needs of market participants in the bond markets and the extent to which there are indications of market failures that would justify regulatory intervention. In this section, we deal with the first two of these areas, and turn to the third in the following section.

Differences between equity and bond markets

10. It is well recognised that markets for bonds and those for equities differ. There are structural differences and a much wider range of instruments and markets, meaning price transparency rules applied to equity markets are not suitable to be transferred to bond markets. The Commission's call for evidence of June 2006 resulted in many of these differences being highlighted by respondents. The key points are summarised in the following table.

Table 1

		Equities	Bonds
Primary Market	*Issuers*	Corporates, financial institutions	Corporates, governments, financial institutions, Special Purpose Vehicles
	Issues	Usually one per issuer	Usually more than one per issuer (perhaps many more)
	Product characteristics	Usually relatively simple	Often more complex, which makes pricing more difficult
Secondary Market	*Investors*	Institutional, significant retail	Institutional, some retail
	Market structures	Order driven; often on-exchange; generally centralised	Quote-driven, RFQs; off-exchange, OTC; decentralised
	Trading frequency	Daily in majority	Daily in minority
	Trading sizes	Small in majority	Large in majority
	Liquidity	High and continuous for many	Depends on issuer, size of the issue, rating, etc. Concentrated mainly in the period immediately after issue.
	Price formation	Based around a dominate trading venue (usually an exchange)	Competitive RFQs; price embodies different information from shares; price formation in bond markets may have mathematical basis.
	Relationship to derivatives	Limited	Closely correlated with credit derivatives.

11. The approach taken by Member States to transparency for non-equity financial instruments provides some insight to what is considered important to have in terms of transparency requirements. CESR provided a summary of bond market transparency on a country-by-country basis (see Annex 2 of CESR's response to the Commission's request for initial assistance on non-equities markets transparency[1]). This revealed that many Member States' regulations in this area (either under national/competent authorities' regulations or venue rules) are, in many respects, broadly alike. This implies that Competent Authorities have formed similar judgments as to the transparency requirements that suit such instruments, given the instruments' nature and the characteristics of their trading. In particular, the transparency summary revealed the following:

- With respect to pre-trade transparency, ten Member States apply the requirements only to transactions concluded on exchanges/regulated markets, four to both regulated markets and MTFs, and three Member States require it for regulated markets, MTFs and investment firms dealing OTC.

- Post-trade information, in one form or another, must be made available by regulated markets in ten Member States, by regulated markets and MTFs in four, and by MTFs and investment firms in five Member States. Such information is made available in real time or within various timeframes, depending on the nature of the transactions. Transparency of OTC trading is considered key for some markets (e.g. in Denmark, where OTC trades are reported to the market within five minutes of execution).

12. Further analysis conducted by CESR in this area forms the basis of the information in Table 3 in the annex to this CP.

[1] http://www.cesr-eu.org/index.php?page=document_details&id=4000&from_id=53

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Section 3: 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?

13. In this section, we discuss the first of the six questions the European Commission posed in its request for assistance. We define market failure and consider the evidence on whether these failures are found in the cash bond markets. We note also some observations regarding derivatives markets and draw conclusions regarding the presence and extent of failures in the bond markets.

Defining market failure

14. Market failures can take a number of different forms and be reflected in various ways. In terms of the failures themselves, there are four broad types identified by CESR's network of economists (ECONET)[2] that are most pertinent for secondary markets in financial instruments. These failures, which would typically arise out of the structure of the given market, are as follows:

- 'Externalities'. These exist where the decisions of one market participant impose costs or benefits on one or more other participants. As market players tend to focus on the impact of their decisions on themselves only, rather than on the broader implications of their actions, the overall outcomes they cause may not be optimal for the market as a whole.

- 'Information asymmetry'. This, as a market failure, arises where one group of participants has more and/or better information than another group. The latter group may make poor trading decisions because of this information shortfall.

- 'Market power'. This tends to arise where there is a lack of competition in a market. Those with power may exploit their influence over the price of the traded instrument (e.g. by restricting supply to force the price up).

- Sub-optimal supply of 'public goods'. This arises where a good from which everyone benefits is not adequately supplied by a market when it is left to its own volition.

15. Clearly, the concepts of externalities, information asymmetry and competition levels may be closely linked in the markets for financial instruments. For instance, where a small number of players dominates the provision of services to clients within a market, the risk that they will have a systematic advantage in gathering and using information, or that their decisions will generate significant externalities, may be greater. This is of significance in the cash bond markets as the market structures differ considerably by bond. For highly liquid bonds, such as on-the-run government debt and large new issues from major corporates, competition between dealers and multilateral trading venues will tend to be high, transparency information relatively easy to obtain, and executions easier to get done. For less liquid securities, however, trading is likely to be dominated by fewer dealers, with executions taking place on a bilateral, OTC basis. Little if any trading will be on multilateral venues. This may reduce the ease of access to transparency information and make it harder for investors to find and judge the reasonability of prices.

16. Against this background, it is also pertinent to examine to what extent trading transparency may be considered a public good and/or whether it is underprovided by the markets. In the market context discussed above, the issue might be reframed as a consideration of the extent to which greater transparency could be used by all, , without harming the markets. This issue, and the possible market failures outlined above, are discussed in the following paragraphs.

[2] See CESR's paper Ref. CESR/07-089.

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17. In this regard it should be noted that market transparency is not supposed to be available free of charge to investors. As recognised by MiFID (in the case of equities) the information is available on a reasonable commercial basis. This is also relevant in terms of information asymmetries. In the financial markets some participants have better possibilities for gaining the information and indeed the capacity to analyse and use such information. These considerations should be taken into account when analysing whether a market failure exists or not.

How market failures may arise

18. There are a number of ways in which trading transparency might be linked to the market failures discussed above:

- Some market participants may have limited access to trading information, or find it prohibitively expensive to obtain. This may affect their ability to determine a fair price at which to trade and, in the case of an investment firm, may impact its ability to obtain best execution for its clients.

- Exploitation of information. Differences in access to transparency information may allow some market participants to exploit others in a systematic way.

- Liquidity and competition. The relationship between transparency, competition and liquidity may be complex – in part because it is sometimes difficult to define what is meant by 'liquidity', as a concept. In some markets, a high degree of transparency may encourage participants to enter, improving trading volumes and bidding down costs and spreads. In such circumstances, transparency might be considered a public good – broadly available and to the benefit of all. However, in other markets – notably, those reliant on dealer-provided liquidity – greater transparency may increase the risk of committing capital and providing prices. Ultimately, this could result in a net withdrawal of liquidity, to the detriment of all participants.

19. Focusing on Europe's cash bond markets, there is clearly a range of participants who have varying access to transparency information – depending, in part, on the particular bond market examined. Investors include the large buy-side institutions (for instance, those operating pension or insurance funds), smaller fund managers, hedge funds and direct retail participants. On the sell-side, institutions are active both as liquidity providers and as proprietary traders.

20. CESR's call for evidence and public consultation attracted 23 responses each. The good majority of these were from trade associations representing banks, securities firms or professionals from these areas. Several were from firms or trade bodies in the fund management or insurance sectors. A couple of responses were received on behalf of trading venues, and from private investors' group. Of these responses, the vast majority felt that there was no market failure affecting wholesale participants in the secondary bond markets that could be attributed to transparency levels. Responses did not generally differentiate between the different types of bonds (e.g. government debt, corporate, etc), although some noted the important differences in market structure mentioned earlier, such as the fact that less liquid bonds are much less likely than liquid issues to be traded on a multilateral venue. The most frequent allusion to differences in the transparency of different markets was that the 'appropriate' level of transparency had usually evolved to suit the major participants in the given market. This would tend to imply that transparency should not be viewed as a public good such that a mandatory increase in its provision would necessarily benefit everybody.

21. These comments closely mirror the responses that the Commission received to its call for evidence last year. But, as with the Commission's responses, a number of respondents to CESR's call for evidence and public consultation – most noticeably, the private investors' group – noted that the bond markets could be a difficult environment for direct retail investors. This arose for a number of reasons. One was that retail investors struggled to gain access to transparency information on the same basis as other participants. They might receive less data, or the data they did obtain might be more delayed, meaning they would be a step behind other participants. This is a comment that was echoed during CESR's retail investor workshop held on 12 and 13 February. Participants at the workshop felt that the low levels of direct retail investment in bonds in most EU jurisdictions were due to the low levels of transparency they could access and that this was a market failure that should be remedied. Another factor noted in the call for evidence responses was that the bond markets tended to be structured in a way that made it easier to trade in large size, often as this was the size in which dealers would want to trade. It was not so easy to trade small (i.e. retail-sized) quantities. Other responses highlighted the value in improving retail investor knowledge of the bond markets and how they operate.

22. A number of other points were also noted regarding the impact of transparency levels. One respondent commented that, while a market failure might not be discernible, promoting greater transparency might still be beneficial if it led to improvements in market efficiency (e.g. faster incorporation of new information into prices). This suggests that greater transparency would be a public good. Other responses noted the difficulty in obtaining aggregated statistics on total market size and activity in the absence of a mandatory and universal transparency regime, and the fact that a lack of evidence of market failures did not necessarily mean that such failures did not exist.

23. CESR has taken on board these comments in considering its response to the Commission's request for advice. We note that the extent of asymmetries may differ according to the bond being traded. For those markets that are more liquid – most obviously government bond markets, but also some supranational and large corporate issues – the ability to access trading information tends to be greater. This is due to the higher levels of multilateral trading – regulated markets and MTFs publish such information – and the greater number of two-way quotes made available by dealers. In addition, end-of-day data for such bonds is published in the financial press.

24. As transparency levels reduce, the possible market failures discussed above may become more likely. Price discovery, and thus the ability to assess prices for best execution purposes, will tend to become more difficult, particularly for smaller players. Competition levels also tend to be lower amongst the dealers offering quotes in such bonds – although this is more a cause rather than a consequence of lower transparency. And concerns may increase regarding the ability of informed market participants and those with market power to exploit their position in a manner considered to be 'unfair' in some respects (i.e. to generate an externality).

25. Further to the above comments, CESR notes the research undertaken last year by the Centre for Economic Policy Research (CEPR)[3] and the UK Financial Services Authority[4] on bid-offer spreads in the bond markets. This suggested that spreads in European corporate bonds were generally tighter than those for their US equivalents, despite the introduction in the US of

[3] Dunne, Peter, Michael Moore & Richard Portes (2006); *European government bond markets: transparency, liquidity, efficiency*; City of London: www.corpoflondon.gov.uk/NR/rdonlyres/26DD01CC-684D-4312-B719-9C9A1F781766/0/BC_RS_TTGovernmentFULL.pdf
Biais, Bruno, Fany Declerck, James Dow, Richard Portes & Ernst-Ludwig von Thadden (2006); *European corporate bond markets: transparency, liquidity, efficiency*; City of London: www.corpoflondon.gov.uk/NR/rdonlyres/49EC04BD-D5BE-4B05-9182-3A8B9E75E0BA/0/BC_RS_TTCorporateFULL.pdf
[4] Financial Services Authority (2006); *Feedback Statement 06/4 Trading transparency in the UK secondary bond markets*: www.fsa.gov.uk/pubs/discussion/fs06_04.pdf

TRACE, a post-trade reporting system. This would tend to suggest that competition levels are good and that European liquidity providers offer better quotes to investors than their US peers. However, parallel research by the CEPR found that spreads for European government bonds tended to be a little wider than those in the US, reflecting the deeper liquidity in US markets from having a single set of benchmark bonds (as opposed to the numerous government issuers within the Eurozone). We examine the CEPR research further in the following section.

Interaction between the cash bond markets and derivatives markets

26. CESR recognises that the growth of the derivatives markets in recent years adds another dimension to the debate around transparency in the bond markets. On the one hand, it is clear that information from the markets for interest rate swaps and credit default swaps may be of value to those trading the underlying instruments and that this adds a further information advantage to sophisticated institutional players. Such participants will be able to access the derivatives markets, understand the information flowing from them and employ this to improve their trading of the underlying – something that the majority of less sophisticated investors would not be able to do. This may exaggerate the information asymmetries in the cash bond markets, increasing the argument that transparency in those markets should be improved.

27. However, CESR accepts also that the existence of the derivatives markets may be of benefit to less sophisticated participants, even if they cannot access (or even understand) them. For instance, the growth of derivatives has allowed dealers to provide greater liquidity to the markets as they are now better placed to manage the associated risks. In addition, the information that firms gain from the derivatives markets, whilst of value to their own trading, may also serve to improve the pricing they are able to offer to clients, suggesting that all can benefit from the development of these markets. Ultimately, the existence of derivatives provides a unified market when the markets for the underlying cash instruments are fragmented.

Comments on other markets

28. Extending the analysis above to other markets within the scope of this review is complex. Derivatives markets vary hugely, from the most vanilla, exchange-traded equity futures to complex, bespoke commodity derivatives that would only trade OTC. In addition, there is a very broad range of market participants that extends beyond the groups discussed above. For instance, oil producers and mining companies may be active in the relevant commodity derivatives markets. What is clear, though, is that relatively few retail participants are to be found in the derivatives markets and, where they do exist, they tend to coalesce around vanilla products that are traded on a relatively transparent basis – e.g. covered warrants or contracts for differences, for both of which pricing information is usually easy to obtain. Unlike in the markets for cash bonds, where some concerns have been raised regarding investor protection relating to transparency levels (see next section), we are not aware of transparency-related concerns in the derivatives markets.

CESR's conclusions

29. CESR has not identified an evident market failure in respect of market transparency on bond markets. Wholesale participants generally seem content with the way in which the cash bond markets currently operate and their level of access to transparency information. Access to transparency information for smaller participants, including retail investors, is not as great, and such participants are less likely to be able to make use of information flowing from associated derivatives markets to aid their investment decisions. With that in mind, CESR believes there would be value to such users in receiving access to greater trading transparency. Greater transparency might also encourage higher levels of retail participation in the markets – although CESR would argue that various other factors,

including the structure of the bond markets, retail investors' understanding of them and the distribution channels used also play an important role in determining the level of retail involvement. Given this, CESR believes any increase in transparency would need to be carefully tailored to ensure that liquidity provision and levels of competition were not damaged as a result of dealers reducing or withdrawing their commitment to the markets. In other words – and as highlighted by many of the responses to CESR's consultation, a thorough cost-benefit analysis should be undertaken by the Commission before any regulatory action.

Section 4: What evidence is there that mandatory pre- or post-trade transparency would mitigate such a market failure?

30. Clearly, where financial instruments are traded on multiple venues, some form of transparency is needed for investors to be able to compare prices and evaluate their trading opportunities. As reflected in the previous section, the benefit of improving transparency in the bond markets would be more significant for retail investors and small/medium market participants than for larger professional investors, which have better access to existing information sources and are better placed to value such instruments. A number of respondents to the calls for evidence from the Commission and CESR appeared to recognise the role played by transparency in helping retail investors and smaller firms, for which information search processes could involve significant costs. In addition, a number of responses noted that difficulty in obtaining pre-trade information could create problems for intermediaries in complying with the stringent best execution obligations laid down in MiFID, which apply to all financial instruments. This would affect the intermediary's ability to identify the venue that offered the best terms for execution and to monitor execution quality for the purpose of reviewing its best execution policy. In other words, the benefits (including reducing search costs) arising from greater transparency could be significant for the markets' smaller participants.

31. Moreover, research on the impact in the US of the TRACE post-trade transparency regime for trading in corporate bonds was mentioned. One respondent noted that this research had identified positive effects in terms of lower trading costs, greater liquidity and competition, and overall net benefits to the markets. The respondent felt that these conclusions should not be overlooked in the European debate. Other respondents however had more cautious, or opposite, analysis.

32. However, as discussed in the previous section, most respondents to the CESR consultation perceived no failure in the bond markets and did not think that further transparency was required. A number of these respondents, and others, noted that mandating greater transparency might have negative consequences for the provision of liquidity. This was of greatest concern with regard to those markets that were particularly reliant on dealer-driven trading, with the mandating of pre-trade transparency being considered of particular risk to dealers' willingness to provide the markets with liquidity. Concerns were also expressed with respect to mandatory post-trade transparency – again, with the focus being on the impact on less liquid markets.

33. Furthermore, a number of respondents commented that the markets continued to evolve, with the growing use of technology resulting in an ever-increasing availability of trading information to users. This, they argued, meant that the markets should be left to develop their own, flexible transparency arrangements, rather than transparency being mandated.

34. There is little academic or institutional literature related specifically to the effects of greater transparency on liquidity in bond markets, and it is a shared view amongst many that those studies related to equity markets are generally inapplicable. Furthermore, the academic literature available on equity markets does not provide definitive conclusions. Some studies emphasise the negative impact that a higher degree of transparency can have on incentives for certain categories of investors to participate in the markets. Other studies reveal that transparency can improve liquidity by reducing search costs for the best quotes and thus encouraging participation.

35. The CEPR studies mentioned in the previous section provide useful contributions on the functioning of bond markets. As discussed, these two reports relate respectively to the European government bond market and the corporate bond market. The main conclusions of the two studies are set out in the following table.

Table 2

Report on European government bond markets	Report on Corporate bond markets
Different levels of transparency are considered appropriate by major market participants. Regulatory imposition of greater transparency could adversely affect liquidity. The preferred course would be to allow transparency to evolve further under the influence of technological and market structure changes.	Euro-denominated bonds have tighter spreads than US corporate bonds, even after the introduction of TRACE. Competition in Europe is a key factor in keeping spreads relatively tight. The introduction of a pre-trade transparency regime would be risky as it would entail requiring significant changes to market microstructures. Greater post-trade transparency would benefit some market participants, such as retail investors and smaller institutions.

CESR's conclusions

36. Bond and equity markets clearly differ, and increasing transparency in bond markets may not have the same effect on price formation and liquidity as in equity markets. Any transparency regime for bond markets should not be designed with reference to the equivalent regime for equities but, as already discussed, with the aim of addressing any identified failure in the markets under examination.

37. Based on the responses to the consultation CESR notes that those participants dominating total trading in bonds do not perceive a market failure, and do not feel that greater transparency should be mandated. CESR accepts that action should not be taken which might harm the operation of the bond markets but notes also that direct retail investors, where they exist, would tend to benefit from an increase in transparency. Transparency levels have increased over time as the markets have developed. But whilst this is deemed sufficient by many participants, it evidently fails at present to meet the needs of these retail investors. With this in mind, CESR observes the following: although there is no evident market failure to be corrected, re-distribution of current transparency information could be useful to help retail participants, but this should occur only if the associated benefits would outweigh the costs to market participants as a whole (e.g. in terms of liquidity provision). Before proposing any regulatory action, the Commission should undertake a thorough cost-benefit analysis. This cost-benefit analysis will differ according to whether pre- or post-trade requirements are considered; any consideration of a transparency regime should have regard to the existing transparency obligations in place and to the ongoing evolution of market-led transparency (discussed in greater depth in Section 8).

Section 5: To what extent can the implementation of MiFID be expected to change this picture?

38. CESR believes that an assessment of the potential costs and benefits of mandatory pre- and/or post-trade transparency obligations for bonds should be made in the light of the changes that MiFID will introduce in terms of investor protection. This was a view that was echoed by many of the respondents to CESR's call for evidence and public consultation.

Transparency under MiFID

39. As far as transparency requirements are concerned, CESR acknowledges that the impact of MiFID in this area cannot yet be assessed. Initially, MiFID applies detailed transparency requirements only for shares admitted to trading on a regulated market. The vast majority of Member States announced that they did not intend to extend these transparency requirements to other financial instruments (an option provided for by recital 46 of MiFID). Indeed, this may lead, in some Member States, to a decision to remove current transparency provisions applying to financial instruments other than shares. If this is indeed what takes place, it would be interesting to see if the regulated markets and MTFs that are currently subject to a pre- and post-trade transparency regime choose to move to a less transparent model when they are no longer obliged to comply with present mandated requirements.

40. Moreover, the Directive will introduce a pan-European regulatory regime for regulated markets and MTFs to create a level playing field. This should result in greater competition between the different venues. It should also create a harmonised approach to ensuring market integrity, fairness and efficiency in the trading process, there being no common regime today. CESR considers that this new environment and the common regime applying to the organisation of trading may result in a more harmonised level of transparency coming about without being mandated – a view with which a number of respondents to the call for evidence and public consultation concurred.

MiFID's investor protection provisions

41. MiFID will also enhance the investor protection regime through requirements related to information disclosure to clients, suitability/appropriateness assessments, management and disclosure of conflicts of interest and best execution obligations. CESR considers that these requirements should help to address concerns regarding retail protection by delivering better prices to investors and protecting them from inappropriate investments. We discuss the specific provisions in greater detail below.

42. First of all, MiFID introduces a best execution obligation for market intermediaries. For the most part, retail investors, as well as small and medium-sized asset managers, rely on their intermediary to assess the quality of the different venues and find the best one to deliver best execution. Where the intermediary is also the venue, or is offering execution in its own bond issues, MiFID provisions on conflicts of interest would also apply, in order to preserve the fairness of the market.

43. To a certain extent, CESR considers that best execution provisions could also result in dealers improving levels of pre-trade transparency. Since intermediaries would be obliged to seek the best price for their clients, competition between dealers may increase on dealer markets as a result of intermediaries searching for the best available price. As a result of these new requirements, retail investors that are less able to access and assess prices should benefit from a higher level of protection. A number of respondents to the call for evidence identified the new best execution requirements as potentially driving further, voluntary increases in transparency. Conversely, however, the argument has been voiced that, in the absence of a mandatory transparency regime, intermediaries will struggle to deliver consistent best execution to clients.

44. As mentioned above, the bond market is characterized by a high diversity of products, associated with very different levels of risk. In this context, the suitability and appropriateness tests introduced by MiFID are of primary importance. The suitability provisions require investment firms providing advice or portfolio management services to take reasonable steps to ensure that the advice given and transactions undertaken are 'suitable' for the client. Where Article 19(6) does not apply (e.g. with respect to execution-only services in non-complex financial instruments), investment firms will be required to assess the client's relevant knowledge and experience.

45. It is not possible at this stage to determine whether such a regime, designed to enhance protection of those investors who have limited understanding of the financial instruments, will result in more or less retail investment in bonds. Furthermore, in many European countries the investor protection regime is already particularly strict and, in spite of it, many mis-selling breaches have still been reported.

46. Moreover, the range of products in the bond markets is complex, from the simplest vanilla government bond to the high-yield and structured markets. Therefore, as an outcome of the MiFID provisions, intermediaries may reduce sales of complex bonds to retail clients (or those that opted for similar protections), and suggest investment in non-complex products (e.g. UCITS funds investing in bonds markets) instead.

Investor education

47. Another consideration raised by some respondents to the CESR call for evidence was the extent of investor education. These respondents suggested that investor protection could be enhanced by initiatives to educate retail participants about bonds and the markets in which the trade. CESR recognises the importance of investor education and notes that the market-led transparency initiative discussed in Section 8 would involve an investor education element.

CESR's conclusions

48. The implementation of MiFID will undoubtedly serve to improve retail investor protection in the bond markets. The best execution requirements will assist retail investors in obtaining fair executions, and the broader measures will help to ensure that retail investors for whom bonds are not a suitable investment are not exposed to the associated risks.

49. CESR is also of the view that harmonising the regulatory requirements for the operators of regulated markets and MTFs will probably result in an increase in transparency provision by trading venues. This should assist intermediaries in obtaining trading information, thereby helping them to deliver best execution to their clients. Nevertheless, it is important to recall that the majority of trading in most bonds occurs away from regulated markets and MTFs. The availability of further transparency might be of value, particularly for smaller intermediaries that are less well-placed to access existing transparency sources.

50. CESR believes also that efforts to promote investor education are an important component in helping retail participants understand and manage the risks associated with the bond markets. We are pleased to note the increasing efforts of the industry to provide educational resources to retail investors.

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Section 6: 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?

51. As discussed above, one conclusion that can be drawn from the calls for evidence and public consultation from the European Commission and CESR is that retail investors may benefit from an increase in access to transparency and other investor information.

52. While an increase in retail involvement might be considered desirable, CESR is very much aware that the bond markets are dominated by institutional investors in some countries. Therefore, mandatory transparency requirements aimed at improving the availability of information to retail customers in order to increase their involvement must not be to the detriment of the wholesale market. When looking for cases where investor protection has been significantly compromised due to the absence of mandatory transparency rules, we have focused on the retail side, as in the wholesale market there does not seem to be evidence of a significant market failure.

53. In the retail arena, it is difficult to identify a case or a pattern of cases where investor protection has been compromised due to a lack of mandatory transparency – as the question as such is highly speculative. The cases in recent years of losses sustained by investors when issuers such as Argentina and Parmalat defaulted on their outstanding debt cannot simply be traced back to a lack of transparency. There was a multitude of reasons for these defaults and, in retrospect, it cannot be claimed that these cases would have taken a different direction if mandatory transparency requirements had been in place. The argument has been put forward in the past that systemic transparency in the form of information regarding debt issuance levels and transparency from trading venues may have been helpful in these cases. However, the vast majority of respondents to the CESR consultation felt that a lack of transparency could not be blamed for these defaults or the associated losses. Rather, they pointed to factors such as corporate fraud as the key causes. More broadly, some respondents argued that the lack of transparency available to retail investors must result in a market inefficiency from their standpoint, although these respondents did not point to particular cases that had arisen. Some respondents pointed out that in some of the cases the lack of transparency contributed to the losses of investors by allowing intermediaries to misuse their position by "dumping" the instruments into their retail clients. CESR recognises that in such cases the intermediary is already violating several conduct of business obligations.

54. One specific transparency-related problem identified in a response to the Commission's call for evidence referred to a different kind of transparency to the MiFID-style transparency for shares. In respect of corporate bonds of issuers whose shares are not listed on a regulated market, there has been concern about a deficiency in terms of the availability of general market information. A proposal to correct this deficiency is the introduction of periodic reporting obligations for securities listed on regulated markets, irrespective of whether the issuer's shares are listed. The Transparency Directive, which had to be transposed into national law by 20 January 2007, entails periodic reporting obligations in the form of annual and half-yearly financial reports for issuers with debt denominated below €50k and harmonises the publication requirements so that this particular concern, to a large extent, has been addressed already.

<u>CESR's conclusions</u>

55. CESR recognises that problems have arisen in the bond markets occasionally and that, in some instances, these have resulted in significant losses for retail investors. However, CESR is of the opinion that these losses were not the result of, nor could have primarily been prevented by, greater market transparency.

Section 7: Could it be feasible and/or desirable to consider extending mandatory transparency only to certain segments of the market or certain types of investors?

56. CESR considers, as a matter of principle, that the pre-trade and post-trade transparency requirements that might arise from EU-harmonised arrangements should take account several factors, including:

    - whether or not the bonds are admitted to trading on a regulated market or are traded on several platforms;
    - the nature of trading in the instruments – e.g. the proportion of trading occurring on MTFs and regulated markets compared to bilaterally;
    - the type of market participants; and
    - the type of end investors who hold these instruments.

57. As highlighted above and by CESR in its initial response to the European Commission on non-equity markets (see footnote 1), the EEA bond markets comprise a number of product markets, including government and non-government bonds, with the latter made up of a wide range of sub-sectors (e.g. asset-backed securities, covered bonds, convertible bonds etc). In terms of trading, there are also broad differences, from instruments traded on electronic platforms to those traded on a purely bilateral, OTC basis.

58. Against this backdrop, CESR received a wide range of responses to the question in its consultation on segmenting transparency requirements. Some respondents took the opportunity to repeat their message that they saw no market failure in the bond markets and so the question of segmenting transparency requirements was beside the point. A large number of respondents suggested that segmented transparency – designed to take into account the particular circumstances of the bond market in question, or targeted particularly at given investor groups (most obviously retail participants) – seemed sensible. Such a segmentation could be delivered regardless of whether a mandatory or an industry-driven transparency solution was adopted. But others argued that differentiating transparency requirements would be difficult to deliver in practical terms and might overlook the fact that, in reality, many of these market segments were interlinked. They also argued that in rapidly evolving markets any regulatory classification would be difficult to establish and maintain.

<u>CESR's conclusions</u>

59. In principle, CESR considers that, subject to careful design, various segmentations could be done. Difference between pre and post-trade transparency is widely recognised. And, clearly, to target transparency towards those participants that currently lack information would seem a sensible proposition. Categorisation linked to trading characteristics could however be more difficult. On the one hand there might be benefits if, for instance, the levels of transparency currently provided across Europe in each segment of the bond markets were harmonised – which is not the case at present. This might benefit investment managers, who would find useful guideposts for pricing the assets they manage, but also those retail and professional investors who do not necessarily have easy access to such information. Once published, the information would allow these same investors to make a more accurate assessment of the quality of order execution they have received; it would also provide intermediaries with a useful frame of reference for establishing their order execution policies and, where necessary, for demonstrating that they have fulfilled their best execution obligations. On the other hand this kind of segregation should be flexible enough to recognise the different needs of each segment and avoid interfering with the markets structure and evolution.

60. As a further consideration, CESR believes that a transparency regime that differentiated requirements based on the type of product may result into artificial effects e.g. some intermediaries systematically deciding to sell certain products to investors compared to others that are not subject to the same level of transparency. This is because, by selling such bonds, these intermediaries may find it easier to ensure they meet the MiFID investor protection obligations discussed above.

61. Nevertheless, any possible EU-harmonised post-trade transparency obligations would need to take account of the risks borne by firms that execute orders for their own account or trade as principals to provide the market with immediate liquidity. The approach used for equities to address the need to protect risk trades may prove relevant in this respect. The technical costs of such an approach might be alleviated given much bond trading information is centralised by professional associations that play a self regulatory role vis-à-vis their members.

Section 8: 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?

62. The industry has proved in recent years that it is capable of developing mechanisms for the delivery of transparency and other information to market users. CESR agrees that it is wise to consider whether an industry-led solution could be developed if an increase in transparency is deemed appropriate. There is a range of criteria that CESR believes the Commission should bear in mind in judging whether an industry-led solution was appropriate, and we would want to see the industry making progress to meet these if such a solution were to be considered viable.

Suggested criteria

63. A broad range of factors were highlighted in the responses to CESR's consultation. The first and most fundamental point was that the solution must be 'fit-for-purpose'. Obviously, any solution proposed by the market would need to meet the regulatory objectives the Commission sets. The Commission, in consultation with competent authorities and the industry, must determine what the ultimate aim of a transparency initiative would be, given the market failure analysis undertaken, before the appropriateness of any given proposal is assessed. As part of this, the following factors would need to be considered:

- The depth and breadth of the information provided. This would need to include the bonds and the information[5] that would be reportable as part of a pan-European regime, as well as the institutions that were caught by the reporting requirements. As part of this, the process for adding new bond issues to the reporting requirements and accounting for firms entering and leaving the markets would need to be considered. An industry solution would also need to account for requirements regarding how data was to be presented – e.g. aggregated or provided on a trade-by-trade basis – and whether volumes data would be offered, etc.

- Taking into account its self-regulatory nature, any solutions should also be able to address appropriate coverage both in terms of geographical distribution and market share.

- The timeliness of the data. Some recipients might wish to have access to data on a near real-time basis, while others might be content with end-of-day publication.

- The delivery mechanism employed. The mechanism – be it a trading screen, the internet, or another avenue – would need to be appropriate for the intended recipient and provide them with a well-advertised, easily accessible source of information. This includes ensuring that the display/presentation of trading information was user-friendly, given the needs of the particular target group. Also, any transparency initiative would need to ensure that all investors within the target group were afforded equal access, irrespective of where they were located within Europe.

64. Notwithstanding the above comments, cost efficiency would be an important factor to take into account. The solution should be subject to a rigorous cost-benefit analysis (CBA) so that the design of any market-led transparency regime factored in the costs that would be incurred. Broadly, these might fall into two categories:

- Direct costs of using the system. On the technological side, the greater the reporting requirements and the faster these must be met, the more extensive the costs are likely to be to the industry. In addition, the charges that are made for reporting via the system should be a consideration.

[5] This might include information on orders, quotes and/or trades.

- Broader costs to the market. Transparency may affect the willingness of dealers to provide liquidity to markets, particularly with respect to high yield bonds. The Commission should have regard to the impact that an industry-led solution – or, indeed, any transparency regime – might have on the efficient operation of the markets.

65. A number of respondents to the call for evidence suggested also that the CBA should be revisited after the introduction of the transparency regime, as well as being undertaken before.

66. A further factor to consider is reliability. Any industry-led solution would need to be resilient and, preferably, to have a track record of delivering similar, high quality information to users. This would help to ensure that it was able to cope with its task from day one. Any proposal for an effective industry solution should set out how reliability would be ensured and what back-up procedures were in place to cope with systems downtime.

67. The final point to note is governance. There would need to be a clear governance structure for the entities organising market-led solutions. The structure would need to provide clear accountability for the organisation and execution of the transparency service and to allow for feedback from users and the providers of the data it carried. It would also need to provide a mechanism for the service to develop over time to take into account developments in the markets (including, potentially, taking on board comments from regulators and the Commission).

<u>Progress in this area</u>

68. The industry continues to develop transparency provision of its own volition. Some of this is delivered by multilateral venues, such as regulated markets and MTFs, and some through firms providing quotes on an OTC basis (e.g. via Bloomberg). Further, the provision of bond and related indices continues to expand (e.g. the iBoxx and iTraxx families of indices).

69. In addition, some efforts are being made to address specifically the concerns that underlie the Commission's review. Work is underway, organised by trade associations, to explore the development of transparency solutions that would aid those who have expressed a desire for greater trading information. As would be expected of industry-led initiatives, these solutions aim to strike a balance between improving transparency where required and avoiding damage to the structure and efficient functioning of the bond markets (in particular, in terms of liquidity provision). A number of options are under discussion, involving either realtime or end-of-day publication of aggregated pricing information (i.e. average daily prices, highs, lows, etc) or trade-by-trade prices. Access to data would be wide, including delivery via the internet.

70. These are clearly positive developments and display a willingness on the part of the industry to take action to improve transparency. And whilst the precise objectives of any push to achieve greater transparency have yet to be defined, offering tailored solutions for retail and wholesale participants would seem sensible given existing access to transparency information is broadly different between these two groups.

<u>CESR's conclusions</u>

71. Evidently, there is a range of criteria that would need to be taken into account in assessing whether an industry-led solution might be adequate. Notably, however, these factors do not differ materially from those that would have to be considered as part of developing a *regulatory* solution. In other words, the issue is perhaps more one of *who is best placed* to deliver the right solution. The fact that transparency – of various sorts and across many markets – is delivered every day by the industry might suggest that any effort to enhance transparency provision in the secondary bond markets was better led by those markets than by regulators. Indeed, the industry may be particularly well-placed to deliver a solution for

markets that, by their nature, are cross-border/multi-jurisdictional. However, if the industry were asked to deliver greater transparency, it would have to demonstrate a clear commitment to doing so; otherwise, it might undermine regulators' confidence in the industry's ability to deliver solutions of its own. The progress of such initiatives should be monitored and their impact analysed. The retail participation on bond market might warrant for wider consideration than just transparency. The forthcoming Commission work on retail financial services could be a possibility for such evaluation.

Section 9: Summary comments

72. In summary, CESR would like to point out the following:

- CESR has not recognised evident market failure which would warrant mandatory transparency for bond markets

- Although there is no evident market failure to be corrected, re-distribution of current transparency information could be useful to help retail participants.

- CESR recognises that there are market-led initiatives currently planned into this direction. The progress of these initiatives should be followed and their effect evaluated before considering any possible regulatory action.

- While not addressing an evident market failure CESR does not see this issue as a matter of immediate urgency. Therefore any possible regulatory action should also take into account the implementation and operation experience of MIFID provisions as discussed earlier in this paper..

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Annex: Existing trading transparency in Europe for listed bonds

This annex sets out in tabular form the existing transparency in European markets for listed bonds.

Table 3: Transparency for listed bonds

Country	Information disseminated to exchange users about trades on the exchange			Information disseminated to the public about trades on the exchange				Listed Bonds traded off-market	Listed Bonds traded on ATS Information disseminated to the public			
	Pre-trade	Post-trade	Set by	Pre-trade	Post-trade	Set by	Disseminated by	Dissemination	Pre-trade	Post-trade	Set by	Disseminated by
Austria	Real-time	Real-time	Regulatory authority and exchange	Real-time	Real-time	Regulatory authority and exchange	Exchange and information vendors	Reported to Regulatory Authority. Not disseminated.	N/A	N/A	N/A	N/A
Finland	N/A*	Real time	General obligation for transparency is laid down by a parliament act, technical details by the Helsinki Stock Exchange.	N/A*	Real time for a fee or delayed	General obligation for transparency is laid down by a parliament act, technical details by the Helsinki Stock Exchange.	Helsinki Stock Exchange	Reported to the central securities depository but not disseminated to public.	N/A (no ATS for bond trading in Finland)	N/A (no ATS for bond trading in Finland)	N/A (no ATS for bond trading in Finland)	N/A (no ATS for bond trading in Finland)
France	Real-time	Real-time	Regulatory authority and exchange	Real-time	Real-time	Regulatory authority and exchange	Exchange and information vendors	Reported to regulator or to the market operator / operator of the payment	N/A	N/A	N/A	N/A

Country	Information disseminated to exchange users about trades on the exchange			Information disseminated to the public about trades on the exchange				Listed Bonds traded off-market	Listed Bonds traded on ATS Information disseminated to the public			
	Pre-trade	Post-trade	Set by	Pre-trade	Post-trade	Set by	Disseminated by	Dissemination	Pre-trade	Post-trade	Set by	Disseminated by
								and settlement system Not disseminated				
Germany	Real-time	Real-time	Regulatory authorities and exchange	Real-time	Real-time	Regulatory authorities and exchange	Exchange and information vendors	Reported to regulatory authorities but not disseminated	None	None	N/A	No transparency requirements
Greece	Real-time	Real-time	Regulatory authorities and Market Operators	Real-time	Real-time	Regulatory authorities and Market Operators	Information vendors	Reported to operator of the payment and settlement system Not disseminated	N/A	N/A	N/A	N/A
Hungary	Real-time	Real-time	Regulatory authority and exchange	Real-time for a fee Delayed for free	Real-time for a fee Delayed for free	Regulatory authority and exchange	Exchange and information vendors	Reported to the regulatory authority. Made public in a limited and consolidated way (Information on OTC transactions completed through the Hungarian	N/A	N/A	N/A	N/A

Country	Information disseminated to exchange users about trades on the exchange			Information disseminated to the public about trades on the exchange				Listed Bonds traded off-market	Listed Bonds traded on ATS Information disseminated to the public			
	Pre-trade	Post-trade	Set by	Pre-trade	Post-trade	Set by	Disseminated by	Dissemination	Pre-trade	Post-trade	Set by	Disseminated by
								Central Clearing House is publicly available in consolidated form by security on weekly basis with a delay of four days.)				
Italy	Real-time	Real-time	Regulatory authorities and exchanges	Real-time for a fee Delayed for free	Real-time for a fee Delayed for free	Exchanges and regulatory authorities	Exchanges and information vendors	Reported to exchange and disseminated in 1 hour	Real-time	Real-time	Regulatory authorities	ATS
Luxembourg	Real-time	Real-time	Exchange under regulatory requirements	Only on request through market members	Delayed publication (min 15 minutes)	Exchange	Exchange and information vendors	Reported to the authority but not disseminated	Only on request through market members	Delayed publication (min 15 minutes)	Exchange	Exchange and information vendors
Netherlands	Real-time	Real-time	Exchange	Real-time	Real-time	Exchange	Exchange and information vendors	Reported to regulator or to the market operator / operator of the payment and settlement system Not	N/A	N/A	N/A	N/A

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Country	Information disseminated to exchange users about trades on the exchange			Information disseminated to the public about trades on the exchange				Listed Bonds traded off-market	Listed Bonds traded on ATS Information disseminated to the public			
	Pre-trade	Post-trade	Set by	Pre-trade	Post-trade	Set by	Disseminated by	Dissemination	Pre-trade	Post-trade	Set by	Disseminated by
								disseminated				
Portugal	Euronext Lisbon - Real-time	Euronext Lisbon -Real-time	Regulatory authority and exchange	Euronext Lisbon - Real-time	Euronext Lisbon - Real-time	Regulatory authority and exchange	Exchange and information vendors	Reported to the exchange until two working days after the transaction is concluded. Disseminated daily.	N/A	N/A	N/A	N/A
	MTS Portugal - Real-time	MTS Portugal - Real-time	Regulatory authority and exchange	Disseminated	Daily and real-time	Regulatory authority and exchange	Exchange and information vendors		N/A	N/A	N/A	N/A
Spain	MERF - Real-time	Real-time	Exchange and regulatory authority	Real-time	15 minute delay	Regulatory authorities and exchange	Exchange and information vendors	Reported to the exchange and disseminated the same day (if they are reported before closing time) or the following day (if reported after the market is closed)	N/A	N/A	N/A	N/A
	AIAF - At request	Volumes, no prices	Exchange and regulatory authority	At request	Volumes, no prices	Exchange and regulatory authorities	Exchange and information vendors	N/A	N/A	N/A	N/A	N/A
Sweden			Exchange			Regulatory	Exchange and	Reported to the exchange	N/A	N/A	N/A	N/A

Country	Information disseminated to exchange users about trades on the exchange			Information disseminated to the public about trades on the exchange				Listed Bonds traded off-market	Listed Bonds traded on ATS Information disseminated to the public			
	Pre-trade	Post-trade	Set by	Pre-trade	Post-trade	Set by	Disseminated by	Dissemination	Pre-trade	Post-trade	Set by	Disseminated by
Retail-markets Institutional markets	Real-time Real-time	Real-time Aggregated info the following day		Real-time Real-time	Real-time Aggregated info the following day	authority and exchange	information vendors	and aggregated info is disseminated the following day before 9.00 AM.				
United Kingdom	Real-time	Real-time for agency trades Delays for principal trades No volumes for dealer trades	Exchange, under regulatory requirements	Market maker quotes	Prices only	Exchange and information vendors	Exchange and information vendors	Reported to regulatory authority but not disseminated	None	Benchmark bonds Within 30 minutes, size cap on volumes disclosed	FSA	ATS and information vendors

N/A: not applicable

* The Helsinki Stock Exchange only formalises members' negotiated transactions in listed bonds and therefore 'pre-trade' is not applicable.