THE COMMITTEE OF EUROPEAN SECURITIES REGULATORS

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

Feedback statement

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Section 1: Introduction

1. This feedback statement provides a summary of the main comments received by CESR to it consultation on its proposals for a report to European Commission on non-equities market transparency. It complements publication of CESR response to the Commission.

2. Article 65, paragraph 1 of the Markets in Financial Instruments 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.

3. 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.

4. 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?

5. 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.

6. CESR has analysed the comments and the response to the Commission reflects the comments received.

7. The next section in this document discusses some general comments raised during the consultation. Sections 3 to 8 address each of the questions in turn.

Section 2: General comments

8. Respondents considered generally the consultation paper being well structured and balanced. They noted that the comments raised in the call for evidence had been listened to. A very general observation was that there is no convincing market failure to justify regulatory intervention. However, it was widely recognised that more information could be provided to retail investors. Finally, wide support for industry-led solutions was expressed.

9. Several respondents raised the issue of timing. In their view it is not the correct time to address the issue. First, market participants are busy with preparation for MiFID. Second, MiFID will introduce several changes to the markets and any analysis should take account of those changes.

CESR´s response

10. CESR would first like to point out that the work is an input to the report to be prepared by the Commission. CESR is bound by the deadline established by the Commission, which in turn is bound by the deadlines in Article 65 of MiFID. That having been said, CESR has recognised that, especially when not required to address any evident market failure, the issue is not a matter of immediate urgency. It should also be noted that the issues raised by retail participants relate to the operation of bond markets more generally, rather than just transparency, which is the subject of this report.

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?

CESR's conclusions in the consultation paper

11. CESR concluded in the CP that 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 call for evidence, a thorough cost-benefit analysis of any change would need to be undertaken.

CESR´s specific questions

Q1: To what extent do you agree with CESR's assessment of market failure in the secondary bond markets?

Comments in the consultation

12. The majority of respondents commented that they do not see a market failure in bond markets. Markets have worked well and evolved over time. The current transparency level reflects the need of different market participants. Some respondents however noted that in respect of retail investors, the level of transparency is not satisfactory.

13. In relation to CESR´s market failure analysis, several respondents pointed out that the fact that information asymmetry exists in the market should not be seen as a market failure per se. They also commented that the analysis on market transparency as a public good is not correct as market transparency does not meet the criteria for public good.

CESR´s response

14. CESR notes the comments and has clarified the text in order to note more clearly that CESR has not found evident market failure in relation to transparency. Additionally the market failure analysis has been clarified. CESR points out that the analysis on transparency as a public good is not intended to mean that transparency information should be available for free. That is even reflected by MIFD where (in the case of equity) the information has to be available on a reasonable commercial basis. The intention of the analysis is more generally to describe that the information even if not useful from a single firm's point of view is useful and necessary to the market as a whole.

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

CESR's conclusions in the consultation paper

15. CESR presented the following conclusion in the CP:

16. 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.

17. CESR has not undertaken a comprehensive market failure analysis, but the anecdotal evidence gained from the calls for evidence make clear 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 may fail at present to meet the needs of these retail investors. With this in mind, CESR observes the following: transparency could usefully be increased to help retail participants, but this should occur only if the associated benefits would outweigh the costs to market participants (e.g. in terms of liquidity provision); 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).

CESR´s specific questions

Q2: To what extent do you agree with CESR's conclusions regarding the impact of imposing mandatory pre- or post-trade transparency requirements?

Comments in the consultation

18. Respondents generally agreed with CESR´s conclusions that any mandated transparency should be considered only if the benefits outweigh the costs. They also agreed that any possible regime should be targeted to the specificities of bond markets and not be copied from equity markets. Finally, some respondents noted that although there seems to be no need for changes on wholesale markets, carefully structured proposals could be targeted for retail markets.

19. Some respondents also criticized CESR´s analysis of the US Trace experience as being too narrow.

CESR´s response

20. CESR has noted the comments and modified the document in order to clarify that in terms of retail markets there may be some benefits from some re-distribution of transparency information. However, a thorough cost-benefit analysis would be needed before regulatory action is considered. Finally, CESR has modified the conclusions regarding the US Trace experience.

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

CESR's conclusions in the consultation paper

21. 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.

22. 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.

23. 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.

CESR´s specific questions

Q3: To what extent do you think retail investor protection considerations would justify mandating pre- or post trade transparency?

Q4: To what extent do you think that the introduction of the new best execution requirements will result in a change in the level of transparency information provided on a voluntary basis by the industry?

Q5: How would you propose retail investor education be improved and delivered?

Comments in the consultation

24. Respondents expressed a mixture of views about the future effects of MiFID. Some noted first that it is too early to anticipate the concrete effect MiFID will have. Others however noted that there will be several improvements to (retail) investor protection after MiFID.

25. Views diverged on the relationship between transparency rules and conduct of business rules. Several respondents commented that conduct of business rules are a priority measure to protect investors, and cannot be substituted by additional transparency. However, contra views were also expressed: ie that the enhanced conduct of business rules provided for in MiFID can not substitute for a lack of transparency. Some respondents were sceptical about whether there will be an increase in transparency post MiFID.

26. It was also noted that due to market structures, retail investors invest into bonds using advisory services which highlight the status of conduct of business rules. The differences between bond markets and equity markets and the need for investor education were also raised. In order to be able to analyse transparency information properly, (retail) investors should have enough information on the operation of bond markets.

27. Investor education was generally seen as important. However, different areas were recognised to fall under this area, starting with information provided by investment firms and ranging from industry associations to action by supervisors.

CESR´s response

28. CESR recognises the issues raised and agrees that it is not possible to determine the effect of MiFID at this stage. Further analysis is needed, taking account of the practical experience after implementation. CESR is however of the view that the text currently already appropriately accommodates that view and no changes have been introduced.

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?

CESR's conclusions in the consultation paper

29. 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 been prevented by, greater market transparency.

CESR´s specific questions

Q6: To what extent do you agree with the suggestion that the defaults that have affected retail investors in recent years have been the result of factors other than transparency? If you feel that transparency levels were of significance in these losses, please explain how.

Comments in the consultation

30. Respondents agreed with CESR´s view that shortcomings on bond markets have been caused by other factors than transparency and that they could not have been prevented by transparency. Some noted that in those cases all types of investors suffered from losses. Some others were however of the view that although the cases were not caused by lack of transparency, it contributed to the losses of retail investors.

CESR´s response

31. CESR notes the comments and has modified the text in order to recognise the views of those respondents who commented that the lack of transparency may have contributed to the losses of retail investors. CESR notes however, that if intermediaries have in such cases misused their position, they would have also violated several conduct of business obligations. CESR now concludes that the losses could not primarily have been prevented by greater transparency.

CESR

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?

CESR's conclusions in the consultation paper

32. In principle, CESR considers that, subject to careful design, it would not be an unreasonable approach to differentiate between categories of bond and trading methodologies, depending on the nature and scale of any perceived market failures. And, clearly, to target transparency towards those participants that currently lack information would seem a sensible proposition. There might be benefits also if, for instance, the levels of transparency currently provided across European 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.

33. As a further consideration, CESR believes that a transparency regime that differentiated requirements based on the type of product may result in some intermediaries systematically deciding to sell these products to investors compared to those 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.

34. Nevertheless, 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.

CESR´s specific questions

Q7: To what extent do you agree with CESR's assessment that any transparency requirements could viably be segmented?

Comments in the consultation

35. Divergent views were expressed in relation to segmentation. The difference between pre- and post-trade transparency was widely accepted. Also separation between retail and professional investors attracted support. The question regarding segmentation between different types of bonds or market segments raised concern. It was pointed out that such segmentation would face practical difficulties and would not keep up to date with market evolvement. It was also noted that such segmentation would be likely to limit the access for retail to certain products. On the other hand some respondents expressed support for segmentation according to different categories of bonds.

CESR´s response

36. CESR has modified the proposal in order to take into account the different response regarding separation on the basis of pre- and post-trade transparency, and the nature of the investor, versus separation on the basis of products.

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?

CESR's conclusions in the consultation paper

37. 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.

CESR´s specific questions

Q8: Do you agree that we have captured the most important criteria that the Commission should take into account in judging possible self-regulatory initiatives? If you think there are other factors that should be noted, please provide details.

Comments in the consultation

38. The respondents widely approved the criteria suggested by CESR, especially that the primary question is who is best placed to deliver the solution. Many respondents went further to express priority for industry-led initiatives. Some also noted that the question is premature since there is no proven market failure and consequently no need for corrective action either regulatory or self-regulatory.

39. It was also noted that in order to be effective, self-regulatory action should cover the markets widely enough.

CESR´s response

40. CESR has taken the comments on board and modified the document to reflect the comments on the coverage of any possible self-regulatory solution. CESR has further clarified that relying on self-regulatory measures entails necessary follow up and evaluation of their effects. Should they not deliver the desirable outcome the need for possible regulatory action should be re-evaluated.