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CESR Technical Advice to the European Commission in the Context of the MiFID Review: Non-equity Markets Transparency

CFA Institute is pleased to comment on the Committee of European Securities Regulators' (CESR) consultation paper on Technical Advice to the European Commission in the Context of the MiFID Review: Non-equity Markets Transparency (the "Consultation").

CFA Institute, through its members' experience in international markets and different investment disciplines, represents the interests of investors and investment professionals to standard setters, regulatory authorities, and legislative bodies worldwide. CFA Institute promotes fair, open, and transparent global capital markets, and advocates for investors' protection.

We welcome the opportunity to comment on issues related to the transparency of non-equity markets. Most non-equity financial instruments trade over-the-counter (OTC) and consequently the markets for these instruments are typically less transparent than for those instruments primarily traded on regulated exchanges. Enhancing the transparency of OTC markets is a key step towards strengthening the functioning and resiliency of these markets. Transparency helps underpin investor confidence and hence CFA Institute firmly supports the intent of CESR's proposals.

We acknowledge the importance of the Markets in Financial Instruments Directive (MiFID) review and welcome the focus on measures to improve financial market transparency. CFA Institute is committed to providing input into the MiFID review and trusts that the interests of investors are fully recognised and considered throughout that process.

Executive Summary

The Consultation considers extending certain aspects of the MiFID pre-trade and post-trade transparency framework to financial instruments other than shares. In particular, the Consultation focuses on the following non-equity markets: corporate bonds, structured finance products, credit default swaps (CDS), interest rate derivatives, equity derivatives, foreign exchange derivatives, and commodity derivatives.

We offer specific comments on the corporate bond market. We offer only general comments on other non-equity markets. We are unable to comment on specific experiences regarding the functioning of derivatives markets and therefore defer to those who are active participants in such markets. Nevertheless, our members have expressed

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frustration at the lack of transparency in the markets, and cited that deficiency as a reason for investment decisions that cost clients money.

In general, therefore, CFA Institute supports efforts to improve transparency in non-equity markets. Greater transparency about all relevant matters enables more efficient price formation, reduces informational asymmetries, and alleviates uncertainty with respect to valuations. These factors strengthen the functioning of financial markets.

Support for transparency in non-equity markets is evidenced by the results of a survey of CFA Institute members, in which just over half of respondents—between 54 percent and 59 percent—indicated it would be valuable to extend pre- and post-trade transparency requirements under MiFID to transactions in instruments other than shares. Amongst the instruments listed, the highest majority opinion, 59 percent, related to corporate bonds.[1] The findings are detailed in Appendix I of this letter.

We note that any mandatory transparency regime for non-equity financial instruments would need to be properly calibrated to the specificities of the structures of these markets. For example, transactions in structured finance instruments (namely asset-backed securities and collateralised debt obligations) are often conducted on a private, bilateral basis, with investors commonly adopting a buy-and-hold strategy. Consequently, there is often little secondary market activity in certain classes of these instruments. Whilst we support CESR's aims, we note that it may be difficult to formulate a transparency framework for these particular instruments that delivers real utility for investors.

Our specific comments on the corporate bond market are summarised as follows:

- Large institutional investors and broker-dealers, who are by far the primary participants in the corporate bond market, often have sufficient access to relevant trade transparency information in the required level of detail. In comparison, smaller retail investors typically do not have access to trade information in the same level of detail due to prohibitive factors such as cost and scarce availability.

- Retail investors are much more likely to be interested in accessing post-trade data on prices and volumes rather than pre-trade quotes. Such pre-trade data are likely to be of limited utility to this class of investor given their relatively infrequent activity in the corporate bond market.

- Pre-trade transparency for the wholesale market enables investors to better gauge the depth of the market and thus helps improve the quality of price discovery and quantity discovery. A potential drawback from displayed liquidity is that certain market participants may be discouraged from posting quotes or taking certain positions due to the market impact risk associated with displayed quotes.

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[1] The results are taken from the report *"Market Microstructure: The Impact of Fragmentation under the Markets in Financial Instruments Directive," CFA Institute (2009)*, available at http://www.cfapubs.org/toc/ccb/2009/2009/13

- Pre-trade transparency information for corporate bonds should include information on the best bid and offer prices quoted by each dealer/market maker, along with associated sizes. It would be appropriate for any framework to allow exemptions from displayed quotes for market participants dealing in sizes that are 'large in scale' relative to standard market sizes.

- CFA Institute supports the broad post-trade transparency framework proposed for corporate bonds, which allows for short deferral of publication for large trades. We recommend that CESR collaborates closely with industry participants in order to establish a set of practicable transaction size thresholds and deferral periods for the post-trade transparency framework.

- We concur with CESR's description of the most relevant post-trade information, such as maturity, coupon, rating, currency, issuer name; price/yield and volume of executed trade; and date and time of execution. In our view, other relevant items include the exercise price and date of any embedded call or put options.

- In principle, CFA Institute supports the provision of consolidated data on the basis that it aggregates liquidity across markets and thus provides investors with a clear and complete picture of prices and trading interest across the trading network.

We attach our response that addresses the questions of the Consultation. Please do not hesitate to contact us should you wish to discuss any of the points raised.

Yours faithfully,

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With headquarters in Charlottesville, VA, and regional offices in New York, Hong Kong, London and Brussels, CFA Institute is a global, not-for-profit professional association of over 100,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 135 countries, of whom more than 88,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 137 member societies in 58 countries and territories.

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Our specific comments relate to the section on corporate bonds and follow the order of the Consultation's questions. We do not comment on the sections relating to other non-equity markets.

I. General Access to Pre- and Post-Trade Information

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 (ABD and CDOs)
   c) CDS
   d) Interest rate derivatives
   e) Equity derivatives
   f) Foreign exchange derivatives
   g) Commodity derivatives

Whilst our members are actively engaged in each of these markets, CFA Institute is not. We therefore cannot comment on specific experiences.

II. Corporate Bonds

CESR comments that the proposed scope of the transparency regime for corporate bonds would cover those bonds for which a prospectus has been published (i.e. including all bonds admitted to trading on EEA Regulated Markets) or which are admitted to trading on a Multilateral Trading Facility (MTF). CESR defines 'corporate bond' as a transferable debt security issued by a private corporation to raise capital with a maturity of at least 12 months.

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

Other such instruments would include convertible bonds and preference shares. Although legally a form of equity capital, preference shares also have elements that are akin to perpetual fixed-income securities. Whilst we believe such instruments are better covered under the equity markets framework, we raise the issue to ensure that they are covered by the transparency requirements of one of these markets.

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.**

Covered bonds are bonds issued by banks that are secured by certain assets (such as mortgages). These bonds share characteristics with both corporate bonds and structured finance instruments, such as asset-backed securities (ABS). The distinguishing feature of covered bonds is that the loans backing the bond issue remain the legal property of the issuer and, therefore, are kept on-balance sheet.

In our view, covered bonds should be considered as corporate bonds for transparency purposes because the underlying assets remain the property of the issuer, and are not legally separate as is the case with ABS.

<u>Pre-trade transparency for corporate bonds</u>

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?**

We are not active participants in corporate bond markets and are therefore unable to comment on specific experiences.

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.**

Asymmetric information exists in the corporate bond market to the extent that smaller (typically retail) investors face constraints in accessing pre- and post-trade data vis-à-vis wholesale market participants. Cost and scarce availability of timely data are the primary constraints.

Large institutional investors and broker-dealers, who are by far the primary participants in the corporate bond market, likely have sufficient access to relevant trade transparency information in the required level of detail.

When determining market participants' access to trade information, consideration should be given to the microstructure of the corporate bond market, which is a dealer-driven market dominated by large banks who primarily conduct over-the-counter transactions. Transactions in corporate bonds are often handled as principal trades rather than agency trades, and order and transaction sizes are typically large. For these reasons, the corporate bond market is less attractive to individual retail investors than to institutional investors, which perhaps explains the asymmetry of information available to each class of market participant.

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

In principle, CFA Institute supports the provision of consolidated data on the basis that it aggregates liquidity across markets and thus provides investors with a clear and complete picture of prices and trading interest across the trading network.

7. **What are the 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.**

Given the low participation rate of retail investors in corporate bonds – which, as we note in question 5, is likely a function of the structure and characteristics of this market as opposed to a function of the level of transparency – we would question whether a pre-trade transparency regime would deliver marginal benefits for the retail market. Retail investors are much more likely to be interested in accessing post-trade data on prices and volumes rather than pre-trade quotes.

Pre-trade transparency for the wholesale market enables investors to better gauge the depth of the market and thus helps improve the quality of price discovery and quantity discovery. A potential drawback from displayed liquidity is that, under certain circumstances, it may expose market participants to market impact risk. This risk can be managed by allowing exemptions from pre-trade transparency obligations if (and only if) the order in question is significantly large in size relative to standard market sizes.

However, given the lack of transparency in such markets today, it is entirely possible that such market impact effects are already factored into the quotes provided for these instruments by dealers. Consequently, the increased transparency resulting from the regime envisioned by this Consultation could increase competition among dealers and, potentially, cause spreads to narrow.

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

Pre-trade transparency information for corporate bonds should include the best bid and offer prices quoted by each dealer/market maker in the bond in question, along with associated sizes. The coupon and maturity of the bond should be disclosed alongside the name of the issue.

A pre-trade transparency framework should be based upon disclosure of information as close to real-time as possible. Pre-trade data should be made available at reasonable cost on non-discriminatory commercial terms. Similar to the pre-trade transparency framework applicable to equities, it would be appropriate to allow exemptions from displayed quotes for market participants dealing in sizes that are ‘large in scale’ relative to standard market sizes.

Post-trade transparency for corporate bonds

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?

CESR comments in paragraph 23 of the Consultation that the following post-trade information is considered to be most relevant:

i. Description of the bond: standardised format of identification (e.g. ISIN code), maturity, coupon, rating, currency, issuer name;
ii. Price/yield at which the transaction was concluded;
iii. Volume of the executed trade; and
iv. Date and time when the trade was concluded.

We concur with these items.

The par value of the bond (typically 100) would also be useful information for investors. We do not think it would be necessary to include the nominal amount issued in post-trade data provided that this information is disclosed in the prospectus.

Other relevant items would include the exercise price and date of any embedded call or put options. This would enable market participants to determine the bond convexity and hence the scope for further price appreciation/depreciation.

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).

To mitigate any potential adverse impact on liquidity, CESR proposes to allow delayed publication of large trades above certain thresholds (analogous to the MiFID framework for equities). CESR also notes that it may be appropriate to allow disclosure of trades without specifying volumes if the transaction size exceeds a given threshold.

The proposed thresholds for delayed publication are based purely on the size of transactions. This differs from the MiFID framework for equities in which deferred publication thresholds are set according to average daily turnover (ADT). CESR notes that the characteristics of the corporate bond market are such that it would be difficult to establish a single criterion (such as ADT) that captures both the volume and frequency of trading in a consistent manner.

The initial proposal for the calibration of post-trade transparency for corporate bonds is set out in Table 1, re-produced below:

Table 1: Initial proposal for calibration of a post-trade transparency regime for corporate bonds

Transaction size (net value)	Information to be published	Timing of publication
Below €1 million	Price and volume of transaction	As close to real time as possible
Between €1 million and €5 million	Price and volume of transaction	End of day
Above €5 million	Price but no volume (but with an indication that the transaction has exceeded the €5 million threshold)	End of day

CFA Institute appreciates the intent behind these proposals and supports efforts to establish a robust post-trade transparency framework for corporate bonds. The broad framework based on deferred publication of large trades is appropriate, and we support disclosure of trades by no later than the end of the trading day. This proposal would provide for consistency with the framework for equities in which CESR is proposing to reduce the existing maximum 3-day delay for reporting of large trades to the end of the current trading day.

However, since we are not active participants in the corporate bond market, we are unable to comment on the appropriateness of the transaction size thresholds proposed by CESR. As CESR notes in paragraph 29, average trade sizes and trade frequencies in corporate bonds vary significantly from one Member State to another. It is therefore difficult to determine how robust or practical the proposed size thresholds are. We therefore recommend close collaboration with industry participants in order to establish a set of practicable thresholds.

Finally, the 'information to be published' should include those items specified in our response to question 9, and not just the price and volume of the transaction.

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

We believe it would be sensible to first determine whether the proposed framework set out in Table 1 is practicable before considering how to refine the framework using other criteria.

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 question the appropriateness of establishing such a benchmark. By specifying a time benchmark, market participants may use that time to the full before reporting trades, thereby subverting the intention to report in near-real time. CESR has noted similar problems in the equity markets in which market participants routinely use the full 3 minutes permissible (beyond which transactions are not determined to be reported as close to real-time as possible) for reporting equity trades[2].

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[2] See *CFA Institute, Comment Letter to CESR Regarding Review of Equity Markets under MiFID, June 2010, pp.15-16*, available at http://www.cfainstitute.org/Comment%20Letters/20100601.pdf

Appendix I

The following survey results (conducted in July 2009) are reproduced from CFA Institute's report on *Market Microstructure: The Impact of Fragmentation under the Markets in Financial Instruments Directive*.

Q11: How valuable would it be to extend pre- and post-trade transparency requirements under MiFID, in a properly calibrated fashion, to transactions in instruments other than shares? *(Asked of those involved in equity markets in Europe)*	**Not Valuable at All**	**Not Very Valuable**	**Somewhat Valuable**	**Very Valuable**	**No Opinion**
Corporate bonds (N=345)	6%	8%	33%	26%	27%
Asset-backed securities (N=344)	6	7	28	28	32
Collateralised debt obligations (N=344)	6	8	27	27	32
Asset-backed commercial paper (N=343)	6	8	27	27	33
Credit default swaps (N=342)	5	8	25	31	31

The results[3] show that just over half of respondents—between 54 percent and 59 percent—indicated it would be valuable (somewhat or very) to extend pre- and post-trade transparency requirements under MiFID to transactions in instruments other than shares. The highest majority opinion related to corporate bonds, with 59 percent support amongst respondents.

Some of the views of respondents are presented below:

[3] A caveat of these results is that the survey focused on equity market participants, and not specifically on non-equity markets.

Box D: *Investors' views on extending MiFID transparency requirements to instruments other than shares*

'The market in corporate bonds is about 25 years behind equities markets in transparency and execution cost efficiencies.'

'This could be a useful development to encourage on-screen depth, and greater consistency in pricing across different market makers.'

'To the extent that many analysts/risk managers use CDS spreads as indicators in models/systems, increased transparency around what drives movements in spreads can be very useful.'

'Transparency is essential for fixed income assets and MiFID would be the right tool to get it in the fixed income space.'

'These are investment vehicles for professionals; requirements for transparency thus should be lower.'