Introduction

- During last months bond markets have registered greater attention from regulators and the industry than in the past. Analysis have been focused on the differences between equities and bond markets and, in particular, on greater complexity of financial instruments, greater use of trading platforms, increased role of retail investors participation on bond markets and greater influence by a wider range of information (i.r. credit risk) in addition to traditional factors (such as interest rates).

- Regulatory analysis and initiatives have seen International and European organisations, such the IOSCO and CESR, actively working on bond market transparency. Furthermore, MiFiD requires the European Commission (EC) to report on possible extension of MiFiD equity transparency provisions to other financial instruments, including bonds.

- Studies from CEPR and UK FSA are important contributions to the knowledge of how bond markets work. ICMA and group of sell-side and buy-side associations funded two research reports by the Centre for Economic Policy Research (CEPR): one on the European government bond market and the other on the corporate bond market.

1. The "industry reaction" to transparency regimes for bonds

- The industry reaction to transparency for bond markets is well represented in CEPR Reports on European government and corporate bond markets. Main conclusions are:

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<td>- Different level of transparency are considered appropriate by major market participants</td>
<td>- Euro-denominated bonds have tighter spreads than US corporate bonds, even after TRACE</td>
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<td>- Regulatory imposition of greater transparency could adversely affect liquidity</td>
<td>- Competition in Europe is a key factor</td>
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<td>- Better course would be to allow them to evolve further under technological and market structures changes</td>
<td>- The introduction of pre-trade transparency regimes would be risky as it would entail requiring significant changes to market microstructures</td>
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<td>- Greater post-trade transparency would benefit some market participants, such as retail and small institutions</td>
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- The industry analysis appear to focus on the presence of any market failures and costs related to transparency regimes. Views and conclusions of the industry could be shared but some of them
are generic and certainly reflect specific situations in which market intermediaries operate.

- Conclusions reached in the two mentioned Report by CEPR appears too conservative. The analysis provided in the Reports could also support additional and innovative proposals.

- Generally, industry reaction focuses on: (i) the differences between bond and equities markets; (ii) the liquidity drawback arising from a transparency regime for bonds; (iii) the absence of any major market failures to justify a regulatory intervention in this area.

1.1 Markets for bonds and those for equities differ

- Discussion of structural differences between equities and bonds are often taken as first and important step to analyse the possibility to have a transparency regime for bonds.

<table>
<thead>
<tr>
<th>Primary Market</th>
<th>Equities</th>
<th>Bonds</th>
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<tr>
<td><strong>Issuers</strong></td>
<td>Corporates, Financial Institutions</td>
<td>Corporates, Governments, Financial Institutions, SPVs</td>
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<tr>
<td><strong>Issues</strong></td>
<td>1 per issuer</td>
<td>More than 1 per issuer</td>
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<tr>
<td><strong>Product characteristics</strong></td>
<td>simple</td>
<td>Complex, which makes pricing more difficult</td>
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<th>Secondary Market</th>
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<tr>
<td><strong>Investors</strong></td>
<td>Significant retail, Institutional</td>
</tr>
<tr>
<td><strong>Market structures</strong></td>
<td>Order driven, On-exchange, centralised</td>
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<tr>
<td><strong>Trading frequency</strong></td>
<td>Daily in majority</td>
</tr>
<tr>
<td><strong>Trading sizes</strong></td>
<td>Small in majority</td>
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<tr>
<td><strong>Liquidity</strong></td>
<td>High and continuous</td>
</tr>
<tr>
<td><strong>Price formation</strong></td>
<td>Exchange</td>
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Fixed-income markets have different segments and the specific characteristics may vary from bond to bond, presenting always more complex structures. Differences may have to do with issuers, issue structures, geography, currency, maturity.

The nature of the trading venues in which the bond can be negotiated affect the method of execution, the level of information available, market participants, market microstructures, liquidity dynamics. Pricing of bonds is obviously linked to the nature and structure of the financial instrument. For example, government bonds have a rate of return largely affected by macroeconomic trends and information widely available; evaluating corporate bonds might be more complex because of the credit risk factor which plays a central role for pricing them.

The development of credit derivatives markets had increased firms’ ability to hedge positions and hereby manage the risks associated with market making. These markets impact on trading activity in cash markets and price formation, making the analysis more difficult.

Industry underlines how trading frequency is higher for shares, bond markets are mainly institutional and bond pricing is made up of additional and different information.

Trading frequency can be low and demand and supply could play a less relevant role in the pricing process for bonds than for shares but investors willing to invest or disinvest their bonds should be provided with the necessary information to be able to assess what the price of their position could be.

The above considerations should not represent the basis for not having any transparency. It should be seen as a need to understand how bond markets work in order to define the transparency regime that better fits their characteristics.

Where financial instruments are to be traded on multiple trading venues, a transparency regime is a precondition for the possibility for investors to compare prices and evaluate their trading opportunities. Such a statement clearly fits retail investors needs more than professional investors ones. However, information on fixed-income markets are still incomplete and lacking with respect to many dynamics to be able to say if bond markets are mainly institutional because of retail investors are not interested in them or because of their opacity which makes it difficult and costly for them to participate. Transparency certainly represent a condition for retail investors to reach a better knowledge and comprehension of the market and their investment decisions, which in turn may generate externalities in terms of retail investors participation in such markets and therefore increased efficiency and liquidity.

The introduction of a transparency regime should be read in terms of analysis of the characteristics of the instruments and the markets on which they are traded to identify the adequate transparency regime for such financial instruments. In light of the regulatory framework and experience in the field of pre and post-trade transparency applying to bonds in Italy, any transparency regime for bonds should take into account the specific nature of
fixed-income markets. This would reasonably involve not only the possibility to have a transparency regime which is different to the one prescribed for shares but also more than one transparency regime for different instrument classes.

* * *

Retail investors participation to markets for bonds

- It is certainly true that fixed-income markets are largely institutional and the latter know where to find the information needed but the possibility for retail investors to access these markets, in one way or another, should be taken seriously into account when considering the investor protection side of the cost-benefit analysis undertaken for the purpose of a transparency regime for bonds. Are bond markets less transparent than those for shares because they are mainly institutional or retail investors do not actively participate bond markets because they are less transparent than those for shares?

- A certain degree of transparency is needed to protect retail investors and uninformed persons. Where financial systems are characterized by a significant retail participation – often used to trade on regulated exchanges - transparency represents a crucial factor and perhaps more important than in systems where institutional investors prevail.

- Retail investors need to seek out the most advantageous trading venue. Where economical and efficient means of publication of the data are not available, information research could involve significant costs in terms of time and money both for retail investors and smaller intermediaries.

- Some studies have found that with the increase in post-trade transparency due to TRACE, transactions costs in the US have diminished. If regulatory intervention were to reduce transaction costs, one would expect greater participation in the bond market by investors previously held back by the relatively high incidence of trading costs on yields. This effect would come under the general aim of increasing investor participation.

- Impossible to say whether limited retail participation is due to low interest in the market or its opacity.

QUESTION ARE:

Should we focus on the differences?

Are structural differences between equities and bonds critical and major factors in the analysis of price transparency?

Should other factors be taken into account?

Have we reached an adequate knowledge of bond market characteristics?

Do retail investors need information to reach a knowledge and comprehension of the market and investment opportunities?
1.2 The liquidity drawback of a transparency regime for bonds deserve attention

- **Despite the key role of bond markets, there has been less academic and empirical attention assigned to bond markets than to equity ones.** One of the main reasons is the little information and datasets available to work on them, due to the lack of transparency of trading information. Most of the academic works available refer to equity markets and even in this case the empirical results are somewhat ambiguous and do not allow any definitive conclusions.

- For example, in areas such the link between transparency and liquidity, some studies emphasises the negative impact that a higher degree of transparency can have on the incentives for certain categories of investors to participate the market and hence on liquidity but some other works revealed that transparency can improve liquidity if customers have to search for the best quotes and that information should be considered a public good so that the optimal level of transparency might not emerge spontaneously. Even the empirical studies on equity markets show how changes in pre-trade transparency can have various effects in different markets and that changes in the post-trade transparency regime in the London Stock Exchange did not alter liquidity.

- **Any conclusions on the impact of transparency on price efficiency and liquidity available for shares should be taken with extreme caution.**

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<th>QUESTIONS ARE:</th>
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<td>Do we have enough information from theoretical and empirical analysis on trade-off between liquidity and transparency to infer the optimal outcome in terms of transparency for bond markets?</td>
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<td>Could liquidity be considered the sole factor to be taken into account?</td>
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1.3 The market failure approach and market-led solutions

- There have been some discussions recently of what was meant by **market failure** and the issue **whether markets worked efficiently and fairly**. Intermediaries have been arguing that **market failures should be identified in advance in order to look for a regulatory intervention for a transparency regime.**

- The industry emphasises how no evidence is available on the presence of market failures. Therefore, it concludes there is no need for a regulatory intervention.

- **Market failures could not represent the lead factor. Rather than focusing on markets failures higher attention should be paid on whether markets could work better and what can be inferred from the observation of market trends.** To this end, market-led solutions are fine but the fact that institutional investors and big intermediaries have access to all relevant information could not represent the ultimate conclusion that markets for bonds are transparent.

| QUESTION IS: |
Even in absence of any market failures, could bond markets work better without any major liquidity drawback?

2. Issues to be taken into account when considering a transparency regime for bonds

- A transparency regime has different options available. The role of pre- and post-trade Transparency varies with typical market participants and with the type of instrument traded.

- A transparency regime should not be seen as necessary only on the basis of comparable conditions between bonds and equities.

- It is essential to understand what we mean by transparency, what definition do we give to transparency and what type of transparency we are referring to. We could look at:
  - pre and/or post-trade transparency;
  - transparency of transactions occurring on-exchange and/or off-exchange;
  - real time and/or delayed transparency;
  - transparency regime for listed and/or unlisted bonds;
  - transparency depending on retail/wholesale nature of the market;
  - transparency depending on the market microstructure (B2B or B2C)

- A transparency regime has different options available which should be analysed taking into account the fact that the so-called "liquidity drawbacks" are different (and could be even "neutralised") under the different options.

- Market structures and regulatory framework in place in the various jurisdictions are different and differences should be taken into account.

- The predictable and relatively secure cash flows, particularly for government debt, offer investors an investment with a return that is normally higher than that obtainable on a cash deposit and with a lower capital risk than an investment in equity. However, bonds are issued by entities crossing the whole credit spectrum and in recent years many issuance have involved complex structures that can be often difficult to price.

- Different investors have different needs. Even professional investors (usually identified as a class of investors having the necessary information and, in any event, able to access the relevant information) have a number of informational needs relating to trading in bonds: these include not only information relevant to immediate trading but also information to facilitate portfolio valuations and information for assessing transaction costs.

- Trading information needs should be carefully identified taking into account:
  - the class of investor (professional, retail) and the type of investors in each class (as larger vs smaller buy-side firms);
  - liquidity of different class of bonds

- For example, in the markets for more liquid bonds, particularly government bonds, a number of multilateral, dealer-supported electronic platforms have been developed. Although many of the
platforms segment market participants, providing either dealer-to-dealer or dealer-to-client services, trading information is often available beyond the immediate participants.

- **The issues involved in any attempt to design a transparency regime for bonds are complex and solutions in this area for bond markets are more difficult to be identified than for shares markets.** Difficulties basically arise form the very nature of bond markets:
  - there is a wide variety of products that present different and complex characteristics;
  - bond markets have been historically fragmented;
  - lack of empirical analysis in this area.

**3. What from the new MiFID environment**

- **MiFID has introduced a comprehensive transparency regime applicable to all transactions in shares irrespective of their execution by all investment firm on a bilateral basis or through regulated markets and MTFs.** MiFID provides a regime in which investors and markets participants are able to assess at any time the terms of a transaction in shares that they are considering and to verify afterwards the conditions in which it was carried out, thereby promoting the efficiency of the overall price formation process and assisting the effective operation of best execution obligations.

  The transparency regime set up by MiFID takes explicitly into account the fact that the business, mechanics and regulation of RMs and MTFs is fundamentally different from that of trade execution by investment firm. In other words, it promotes the disclosure of as much as trade information as possible, considering the fact that the same degree of transparency is not suitable for all business models.

- **MiFID does not introduce any transparency regime for bonds. However, Recital 46 of MiFID allows member States to decide whether to apply pre and post-trade transparency requirements to financial instruments other than shares.**

- **MiFID requires investment firms to report to competent authorities the details of transaction concluded on financial instruments admitted to trading on regulated markets.**

  Such information – although limited to those financial instruments admitted to trading on regulated markets - could provide useful insights and deeper knowledge on bond markets functioning.

- **MiFID requires investment firms to implement adequate mechanisms to comply with best execution requirements, which apply with respect to all financial instruments.**

  It is quite evident the importance of an adequate level of in order to allow market participants carrying out the appropriate mechanisms to verify the quality of order execution. Adequate transparency also allow retail investors to verify the quality of their orders executed by intermediaries.

  * * *

- In Italy, the Consolidated Law (Legislative Decree 58/98) amended to implement MiFID
provisions has been posed under consultation by the Ministry of Economics and Finance. In the area of transparency, the Consolidated Law assigns to Consob the decision – on the basis of orderly conduct of trading and investor protection reasons – on possible extension of the pre and post-trade transparency regime to financial instruments other than shares.

- In the new environment laid down by the Consolidated Law, Consob:
  - will receive the details of transactions concluded on financial instruments (bonds included) admitted to trading on regulated markets;
  - can ask to receive details of transactions concluded on financial instruments not admitted to trading on regulated markets;
  - can introduce pre and post-trade transparency requirements also for financial instruments other than shares admitted to trading on regulated markets.

- In Italy, bonds are traded on retail regulated markets, wholesale regulated markets, multilateral ATSS and a number of bilateral ATSS. All the trading venues benefit a pre and post-trade transparency regime for transactions carried out on listed bonds, which is differentiated on the basis of the type of trading venue and participants (wholesale vs retail) and type of bonds traded. A certain degree of transparency is also available for unlisted bonds traded on ATSSs.

- For Italian retail investors, bonds are a major component of total financial assets (22.4%). By contrast, the lowest figure is that for the UK (just 1.5%), while the US is at an intermediate level (6.9%). Where deposits and cash are excluded to take into account only investment in financial products, the portion of bonds in Italian retail portfolios rises to 30.7% (against 2% for Britain and 7.9% for the US).

- Bond trading in Italy occurs for a large part on ATSS (so called Sistemi di Scambi organizzati). Some data could be useful to provide a picture of the importance of the more than 300 SSO in this area:
  - on 341 bilateral SSO, 313 SSO register a daily average number of contracts which is less than 50; only 28 SSO have a daily average number of contracts which is more than 50 and, among them, just 2 SSO have is greater than 500
  - on 4 multilateral SSO, 3 of them have a daily average number of contracts which is more than 100
  - 27,353 bonds are traded on the SSO; among these, 24,713 are bonds issued by credit institutions, 1,127 are corporate bonds and 481 are government bonds
  - bonds issued by credit institutions are for the most part (21,735) traded on just one SSO; many bonds issued by credit institutions are traded in less than 5 SSO; only few of these financial instruments are traded on more than 20 SSO

- Any decisions in this area should carefully take into account costs and benefits associated to a transparency regime. The regulatory framework and the transparency regime in place in Italy have proved to work well and, on the basis of the information available, did not have a negative impact on liquidity and investments strategies. However, the absence of an harmonised approach at European level could create the risk of regulatory arbitrage.
• It should be noticed that regulated markets in Europe show the intention to maintain existing transparency requirements for bonds in order not to assist to a diminishing level of information available for bonds as a result of MiFID "lack of regulatory intervention" in this area.

• Article 65 of MiFID requires the European Commission to report to the European Parliament and to the 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. On June 2006, the Commission published a Call for Evidence.

• In general terms, the Call for Evidence revealed:

  a) an opposition at varying degrees to the introduction of mandatory transparency obligations for financial instruments other than shares. Reasons for such position refer to significant differences between equities and non-equities financial instruments, absence/no evidence of market failures warranting regulatory intervention, well functioning of non-equity markets and adequate level of information available to participants, and possible adverse impact of market transparency regimes on liquidity in non-equity markets;

  b) less opposition to post-trade transparency and open-minded approach towards the possibility to advocate separate consideration to retail investors and different types of markets participants who might have difficulties in gaining access to market information.

• In August 2006, the Commission requested CESR initial assistance on non-equities market transparency with the aim of conducting a fact-finding exercise in relation to cash bond markets. CESR provided its response to the Commission’s request revealing that: (i) there is lack of comprehensive, harmonised information on nature and size of EEA bond markets. As a general observation, the information available on government bonds is generally viewed as more precise than that available on corporate bonds; (ii) pre and post-trade transparency requirements in member States are generally set up for/by regulated markets and, in some cases, for MTFs. Similarly, a prime source of information is the regulated market or the MTF and subsequently data vendors; (iii) there are some common characteristics in bond market users and structures in the EEA; however, there are also some key differences on the above between member States. Such differences also refer to the level of retail involvement in bond markets.

• On 27 November 2006, the Commission requested CESR further assistance with regards to the Commission’s work under article 65(1) of the MiFID and asked for an advice on a range of further topics.

• CEPR work on corporate bond markets concludes that "it would be premature and risky to impose pre-trade transparency via regulation". At the same time, the report concludes that "it would be reasonable to introduce some limited post-trade transparency", involving anonymous reporting, a delay of one day and the trader size not exactly reported. The market itself could lead such changes, also if "it may doubted, however, that existing incentives will lead to this outcome".

• ICMA has recently provided a specific proposal for increased post trade transparency in international debt securities. It concerns the publication of an end-of-day tape of all trades in the larger, most liquid investment grade bonds in any currency. The tape would include the details of security, the time of trade, and the size up to certain limits. The proposal also concerns the
development of a retail investor website intended to provide information and educational material about investing in bonds to retail investor.

- Mr. Garbi, member of ESME, is proposing the implementation of a ratings system which would determine the level of pre-and post-trade transparency for non-equity products. When a product is issued, the issuer together with the intermediary will define the minimum level of transparency that all the intermediaries selling products to final investors are obliged to provide.

- As far, discussions and analysis reveal:
  - a strong opposition to mandatory pre-trade transparency requirements for financial instruments other than shares;
  - less opposition to post-trade transparency;
  - any changes in the transparency regime should take the form of market-led solutions.

**Summary and Conclusions**

- **Any decisions on transparency regimes should take into account the specific type of market and financial instruments traded** on it.

- There is not a unique type of transparency. A **transparency regime has different options available and before drawing conclusions it should be clear what transparency we are referring to.**

- The **IOSCO report underlined that regulatory authorities – assessing the appropriate level of transparency – should take into consideration a number of factors, including:** the size of the market, the frequency of trading of particular bonds or group of bonds, participants in the market, the credit ratings of the issue, the trading methodology, the potential effect of any disclosure on the liquidity of the market and whether bonds are listed and the existing exchange transparency standards.

- **Bond markets are very different from equities markets. The transparency regime designed for equities cannot simply be applied to bonds. However, there is a risk that any discussions on a transparency regime for bonds become too generic**. A transparency regime could be reasonably different to the one prescribed for shares but could also envisage different transparency regimes for different instrument classes.

- **An adequate knowledge of bond markets is essential to take any decisions in the area of transparency.** The introduction of a transparency regime should be read in terms of analysis of the characteristics of the instruments and the markets on which they are traded to identify the adequate transparency regime for the financial instruments. The importance of analysis and deep knowledge of bond markets by regulators and market participants has been already underlined by IOSCO Report on "Transparency of bond markets".

- **Statements like "there is no evidence of market failures and therefore the transparency regime in place has to be considered sufficient and adequate" are not correctly posed.** The characteristics of fixed-income markets as well as costs related considerations should be taken into account. However, they could not represent a limit to the introduction of a transparency regime where investor protection and market efficiency reasons require to proceed towards
transparent markets on the basis of costs-benefits analysis.

- **The questions to be answered are:**
  
  - "could bond markets work better and is it possible to improve the quality and amount of information without major liquidity drawbacks?"
  
  - "could liquidity be seen as the sole factor to be considered in the analysis of a transparency regime for bonds?"

- Additional factors should be taken into account:
  
  i) **the benefits (also in terms of costs reductions) arising from greater transparency** : MiFID stringent suitability requirements and effective implementation of best execution obligations imposed on retail brokers plays a central role in the protection of investor rationale. Improved dissemination of price information helps brokers fulfilling their obligations and empower retail investors to monitor the quality of execution received from their brokers.

  ii) **the nature of investors participation to bond markets** : some national markets in the EU have a retail segment that is both significant in scale and active across a wide range of bond markets segments. Retail investor needs in the bond markets (primary and secondary) have a rather different focus and emphasis from those of the professional investor. A primary need of most retail investors, over and above the information and/or advice relating to suitability of particular bonds, is the information relating to price and current trading opportunities.

  iii) **the development of bond markets also requires specific attention**. In this respect, no definitive conclusions could be given whether bond markets are mainly institutional because of retail investors little interest in them or, given bond markets' "opacity", retail investors find it difficult and costly to participate.

  vi) **entry barriers to market and information for bonds should be minimised**. In this respect, it is essential to ensure that the risks of "selective" and "costly" disclosure of information on bond markets are adequately considered and minimised.

**QUESTION IS:**

**Who is going to take decisions on the adequate transparency regime for bonds?**

- It is difficult to find a transparency regime that makes everybody "happy" and the risk of over-regulation is "around the corner".

- **The industry view should be adequately taken into account considering market participants' knowledge of market strategies and dynamics.** Market-led solutions in the area of transparency are therefore welcomed. **However, market forces may fail to reach the adequate level of transparency (making bond markets opaque and not accessible to all type of investors) since they might gain from opacity, they might not have the proper incentives to reach the optimal outcome and they might not care enough about externalities.**
• It should also be recognised that market participants often prefer operating in opaque markets, as in the case of bonds issued by credit institutions where there are lower incentives to make the necessary information available and comparable.

• On the other hand, if any decisions is not supported by an adequate knowledge of bond markets, the risk of over-regulation is around the corner.

• It seems that the maintenance of actual transparency requirements for regulated markets do not represent an issue. However, bond trading mainly occurs on OTC markets and there is an active trading activity also on non-listed bonds.

• Market-led solutions in this area (such as ICMA proposal) represent a good starting point of how the market could benefit from a certain degree of transparency. However, non-regulatory initiatives could fail to reach an adequate level of transparency and, therefore, their initiatives should be coupled with an active role played by regulators, who have the "moral duty" to intervene and find/evaluate the solutions identified on the basis of a cost-benefits analysis.

• Proactive and coordinated analysis in this field between regulators and the industry is necessary, even if, in the end, only a certain level of post-trade transparency would emerge as unique agreed solutions for bond markets.

• Italian markets have been characterised by a high level of transparency, higher than those required on other EU member States; any transparency regime that would require lower level of transparency on bond markets could represent a significant loss for Italian financial markets.

• In Italy, bonds are actively traded on regulated markets (more than elsewhere); however, trading on OTC markets is still relevant, such as trading activity occurring on SSO (where non-listed bonds are also traded). Given the new regulatory environment designed by MiFID, the "SSO phenomenon" should be carefully analysed to understand the solution which could preserve at least the actual level of information available together with the possible business developments and the growth of bond markets.

• Once again, the importance of proactive and constructive dialogues and analysis between regulators and market operators/participants should be strongly supported. As a regulator, I would like to say that market rarely suffers from greater level of post-trade transparency.