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29. July 2004

Re: Response to CESR Call for Evidence on MIFID second mandates

Dear Sirs,

The Bond Market Association (the "Association")¹ welcomes this opportunity to respond to CESR's call for evidence on the second set of mandates from the European Commission on the Markets in Financial Instruments Directive (MIFID).

The Association has worked closely with and supports the general comments made by other trade associations². In particular we agree with their comments regarding the short timetable available, the generally over prescriptive level of details and the need to determine priorities, to provide for grandfathering and to carry out additional fact finding.

As a representative of the international fixed-income dealer community, the Association is particularly interested in ensuring that CESR's technical advice on trade transparency generally across MIFID, and specifically on pre-trade transparency in Article 27, explains:

- (i) why it is important that the current provisions apply to equity markets only; and
- (ii) why, despite Recital 46, Member States should be discouraged to apply such provisions to national debt markets until the two-year review period envisaged by Article 65(1) has been completed.

It is difficult to see how the current transparency provisions in MIFID, and Article 27 in this case, could be easily transposed to a fixed-income environment. For example:

- (i) The triggering requirement for Article 27 is that the financial instrument must be "admitted to trading on a regulated market for which there is a liquid market". In the case of bonds, (a) most bonds (including listed bonds) trade off-market (see IOSCO's report dated May 2004 on Transparency of The Corporate Bond

¹ The Bond Market Association is an international trade association representing approximately 200 securities firms and banks that underwrite, distribute and trade in fixed income securities internationally. More information about the BMA and its members and activities is available on its website www.bondmarkets.com.

² See the joint comment letter of 29. July 2004 by the International Swaps and Derivatives Association, the International Securities Market Association, the Association of Norwegian Stockbroking Companies, the Bankers and Securities Dealers Association of Iceland, the Danish Securities Dealers Association, the Finnish Association of Securities Dealers, the London Investment Banking Association, and the Swedish Securities Dealers Association.

Markets, page 6); and (b) bonds do not in fact generally trade and the markets are therefore generally illiquid (see paragraph 4 below).

(ii) The various obligations on Systematic Internalisers regarding the publication of quotes and determination of standard market size(s) would force bond dealers to assume substantial capital risk because of the lack of liquidity in the bond markets. Historically, bond dealers have quoted 2-way prices only for the most liquid (usually government) issues.

The above simply reflect the more general conviction of the Association that there are important characteristics distinguishing the bond markets from the equity markets. These differences have resulted in a market structure and regulatory system for bonds that are purposely distinct from the same systems for equities and include, in very broad but important terms:

(i) Market diversity: there are many more bonds of different issuers outstanding than shares, and even bonds issued by the same issuer may have different terms and structures, making them more difficult to value.

(ii) Market structure: bonds trade almost exclusively on an over-the-counter, dealer based, principal market rather than on an exchange or national market system. Thus, a dealer's willingness to commit capital to dealing activities is more critical to market liquidity.

(iii) Issuance: a significant portion of bond issues are sold as private placements which puts them out of the reach of individual and small institutional investors.

(iv) Liquidity: most bonds rarely trade because most investors employ a "buy and hold" philosophy to avoid the effect of changes in interest rates on bond prices.

(v) Investor base: Although the retail presence in the bond markets is increasing, the overwhelming majority of bonds are sold to institutional investors. Consequently, it is important that the regulatory scheme not impose protections appropriate for a retail market on the wholesale market.

(vi) Pricing: we note CESR's statement (page 85) that "pre-trade transparency aids price formation..." and would respectfully disagree that this is the case for most bonds. In general, bonds are priced in relation to the current and expected yield curves for low or no-risk securities (eg, sovereign debt, large corporates) having similar characteristics, adjusted to take account of the credit risk of the issuer (which is often determined by independent credit rating agencies) and of current and anticipated changes in interest rates.

The Association is committed to the Commission's and CESR's overall goal of increased post-trade transparency for investors and other market participants. As the

voice of the bond markets, we would also note that an active and liquid market depends on the willingness of bond dealers to buy and sell bonds actively and put capital at risk. Echoing some of IOSCO's Core Measures in the above-referenced report, the Association therefore urges CESR to carry out a detailed analysis of the bond markets in order to assess the appropriate level of transparency required to achieve MIFID's stated goal of ensuring market efficiency and investor protection, whilst preserving the bond dealers community's ability to commit capital. The Association would be delighted to assist in this exercise.

In closing, the Association sincerely appreciates the opportunity to respond to this Call for Evidence and look forward to a continuing dialogue with CESR on the issues highlighted above. Please do not hesitate to contact the undersigned should you have any questions or wish to discuss any of the above in more details.

Yours sincerely,

Bertrand Huet-Delaherse
Vice-President
European Legal and Regulatory Counsel