ICMA

September 15, 2006

ICMA response to the Commission's Call for Evidence:
Pre- and post-trade transparency provisions of the MiFID in relation to transactions in classes of financial instruments other than shares

Executive Summary

The European bond markets are a European success story[1]. They are the most integrated of Europe's securities markets, characterised by an efficient and highly competitive OTC trading structure and (with the exception of national government bond markets) by low cost centralised settlement. Liquidity is provided by dealers trading against their own capital in competition with each other. Corporate bond spreads are generally narrower than in the US and institutional investors appear content with current levels of pre-trade transparency and achieved prices. As the self regulatory body for the bond market, ICMA already operates a reporting system for its reporting dealers that supplies both quote and trade data into the public domain. Furthermore, we are currently in discussion with our members about increasing our provision of post trade data.

We will return to the Commission early in 2007 with our conclusions which we believe will have the support of a critical mass of buy side and sell side participants in Europe's bond markets. We will then be anxious to engage in substantive dialogue concerning the self-regulatory option. In particular, assuming we proceed with phased or experimental introduction of enhanced transparency, we would welcome close cooperation with and advice from the Commission and CESR, and indeed the academic community, on the details of our plans, their relevance to the appropriate regime for best execution in dealer markets and on how to assess whether there are any adverse effects on liquidity.

Introduction

The International Capital Market Association (ICMA) welcomes this early opportunity to contribute to the thinking of the Commission as it begins work on the report it is mandated to produce to the Parliament and Council under Article 65(1) of the MiFID and we look forward to an ongoing dialogue with Commission Services in the months ahead. We trust that our presentation on July 14 of the latest version of ICMA's trade matching and regulatory reporting system, TRAX 2, and the quote and trade data and other information ICMA currently provides to investment firms, issuers and investors was helpful background to both the status quo and the possibilities for further development driven by the needs of market participants. We stand ready to provide further information if requested and as discussed further below we would welcome Commission involvement in our work on introducing further changes to our reporting system.

The response to the Call for Evidence is in two parts. In the first we seek to answer the comprehensive and thoughtful questions it poses. In the second we use the opportunity provided by the last question, Question 16, to discuss the current and possible evolution of the self regulatory approach on which the global success of the international bond market has been based since its establishment in Europe over thirty-five years ago.

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[1] From its origins in the early 1960's the international Eurobond market has become the largest non-government debt market in the world. New issue volume in 2005 was €2.5 trillion and, while reliable turnover figures are difficult to obtain, ICMA believes that the cash market traded in excess of €58 trillion. Related repurchase agreement business totalled some €168 trillion.

Questions for consultation

1. Do you have any comment on the proposed scope of the Report?

We believe that the scope of the report covers the requirements as set out in Article 65 of MiFID and sets out an approach which offers scope for an extensive exploration of the issues in the context of the numerous sectors into which the markets for non-equity instruments are divided. In particular we welcome the willingness of the Commission to consider more than one outcome to its options for intervention.

2. Do you consider this classification scheme to be sufficient for the purposes of the review?

Yes. Given the limits of the Commission's resources to investigate each market in detail, as the Call for Evidence notes, we believe that the level of granularity proposed should enable the Commission to drill down to the level of detail necessary to develop recommendations which will take full account of the different characteristics of the various non-equity markets established in Europe.

3. Do you consider there are possible policy rationales for mandatory transparency we have not listed?

No. We think that the possible policy rationales for imposing mandatory transparency set out in the call for evidence and grouped under the headings of Investor protection, Market efficiency and Response to Technological Developments are comprehensive. We would however suggest that each element be considered in the context of a market failure analysis on which, in recent months, significant new and, we believe, reliable information has been published by, for example, the Centre for Economic Policy Research and the UK Financial Services Authority. We welcome the willingness of the Commission, as discussed in section 5, to consider a range of options for intervention in the event that a problem is identified, including 'no change' and reliance on self-regulation as possible alternatives to the imposition of mandatory transparency.

4. Do you agree with our proposals for prioritisation of the review?

Broadly yes. However, the prioritisation of the cash government bond market seems to us inappropriate given the current high levels of pre- and post-trade transparency that currently exist and the mathematical basis on which prices are determined. If problems do exist in the Government market, and the CEPR study of Professor Richard Portes identified some, it does not appear that mandatory transparency would resolve or ameliorate them, and according to Professor Portes could make matters significantly worse.

We would however like to quote his words, which we believe to be of general application:

'The very existence of most financial markets depends on striking a balance between transparency, thought to promote competition, fairness and investor protection, and opacity, in the interest of encouraging ongoing participation of both end-customers and liquidity providers'

5. To what extent do you consider there to be:

a. observable or demonstrable problems with respect to the possible policy rationales for transparency identified above in relation to one or more of the instrument markets under review?
b. evidence that mandatory pre- or post-trade transparency would solve any of those problems?

We take the three rationales in turn:

<u>Market Efficiency</u>

Over the past eighteen months, new research and analysis on the first three EU instrument markets under review (including, by implication, related derivatives markets) has been presented, notably by the Financial Services Authority (FSA) in their Feedback Statement 'Trading Transparency in the UK Secondary Bond Markets' (published 5 July), The Bond Market Association (BMA), and the two Centre for Economic Policy Research (CEPR) studies published on 24 May 2006. Although separate initiatives, this body of evidence supports a view of well working market forces in those markets characterised by a high degree of competition, rapid technological and market growth and developments, including, where appropriate, an increasing degree of pre- and post-trade transparency, and a lack of evidence that those markets are not capable of delivering a broadly optimal level of transparency at any point in time. We also think this body of evidence supports a view that mandatory pre- or post-trade transparency, particularly the former, could damage these markets.

Nevertheless, both CEPR and subsequently the FSA suggest that there might be some merit in further 'formal' post-trade transparency in corporate debt markets. However the paucity of evidence of 'problems' taken together with a lack of evidence that benefits will arise, and some evidence that, mis-handled, more formal post-trade transparency could lead to a decline in liquidity, leads to a conclusion that more formal post-trade transparency needs to be carefully handled and market-led. We support this conclusion, note the related views of some institutional investors and plan to work with our members and other associations on this matter.

In contrast, factual evidence on the markets for high yield and other debt instruments has not yet been developed to the degree it now exists in the sovereign and investment grade corporate debt markets. ICMA is seeking to address that issue and is co-funding a further research project, the results of which are expected before the end of 2006.

The relative illiquidity of the high yield market and the complexity and bespoke nature of most asset backed securities can, it is said, lead to problems with regards to the pricing of the securities whether at the point of trading or for portfolio valuation purposes, but it is not clear at present that mandatory pre-trade transparency would be practical or that mandatory post-trade transparency would provide useful information. Anecdotally it appears that these markets are evolving rapidly, are highly competitive and there is evidence that they show considerable capacity to take on board and reflect (where efficient) user preferences.

<u>Investor protection</u>

While we are not aware of problems that are symptoms of market failure open to mandatory transparency as a solution, we are aware that others have raised

issues that they consider to be problems in respect of retail investor activity in bond markets. These concerns seem to concentrate on two points:

- Inappropriate levels of retail exposure to sovereign or corporate defaults;
- Low level of direct (as opposed to indirect, through funds) retail participation in bond markets

On the first issue, we believe that good implementation of MiFID is the proper regulatory tool for managing this risk, notably the effective enforcement of the new investment advice and best execution provisions. We look forward to timely and consistent implementation of these MiFID provisions. To the extent that 'execution-only' retail remains a concern, it is worth noting that being a professional investor was no guarantee of protection from loss. On the default of Parmalat, for example, many major institutional investors suffered significant losses from their holdings of Parmalat bonds. In the United States, Moody's estimated total exposures of US life insurance companies to be as high as $1.6 billion among 27 companies. In the UK, six bond fund managers were reported as holding over €45 million in Parmalat bonds. Consequently mandated post-trade transparency is unlikely to be an effective regulatory protection for 'buy and hold' execution-only retail investors. Support for better investor education should also have a role to play.

On the second point we agree with those who argue that limited direct retail participation in the bond market is due mainly to a number of structural features of the bond markets that are unlikely to change in the near term. We note that trading information on bonds is, in general, less accessible to retail investors than on equities but we are not convinced that access to transparency information is a critical factor in determining participation. More important is the fact that retail investors that do buy bonds hold them for the long term, rather than trading them actively. In short, we do not think that issues over retail participation in bond markets relate to market transparency.

We agree with the conclusion in the FSA feedback Statement that

'no case has been made for mandating greater transparency to address potential problems raised for retail investors in the UK. To the extent that additional transparency may be desired, we think an industry-led initiative to deliver targeted enhanced transparency would be a more effective solution than regulation'.

We would suggest that an important question for the Commission is whether the results of the FSA analysis and its conclusions apply more generally across the EU. For our part, we in principle support the notion of an industry-led initiative to enhance transparency for retail investors, and are keen to engage further with the Commission on this topic as discussed below.

<u>Technological development</u>

(See answer to Q6 below)

6. To what extent could recent and upcoming technological and market developments in relation to the instrument markets under review:

a. contribute to a relatively inexpensive extension of mandatory transparency?
b. render mandatory transparency unnecessary?

As set out in more detail in the body of evidence cited in this response, notably the CEPR research, we think it is clear that all of the markets under review are experiencing rapid technological and market growth and development, including, where appropriate, an increasing degree of pre- and post-trade transparency. We also note again that this evidence not only does not support a case for mandatory (i.e. regulatory driven) transparency, but raises the real potential that mandatory transparency could be harmful to the cause of well-working capital markets in Europe.

7. ***To what extent are non-equity financial instruments different from equities so that lower levels of mandatory transparency in those markets may be justified?***

The significant differences between equity and non-equity markets have been well documented in the evidence cited in the research reports listed in the bibliography to the Call for Evidence and we discuss them briefly in our response to question 11. We conclude that it would be surprising if the optimal degree of transparency in each did not differ. Unfortunately it is difficult to comment on the comparison between equity and non-equity markets because we are not able to observe the counterfactual of equity markets without mandated transparency. However, mandatory transparency and actual transparency may be different. The fact that there is currently little mandatory transparency in non-equity markets, doesn't mean that there is no transparency in these markets, as various surveys have demonstrated, just that this transparency arises from market forces rather than regulation.

8. ***What data sources do you consider relevant to the issues you have raised (if appropriate, cross-refer to your answers below)? Would you or your organisation be prepared to produce any relevant data if necessary?***

Please see the data derived from ICMA's data base and the TRAX trade matching and regulatory reporting system set out in Annex 2. We have already indicated to the Commission that it is welcome to have access to further data.

9. ***Are there academic or institutional papers or ongoing work that should be considered in preparing the Report not included in our bibliography?***

Yes. The FSA Feedback Statement.

10. ***What conclusions do you draw from the existing academic debate and the ongoing work being conducted by the interested parties?***

Our conclusions from the most directly relevant work are set out earlier in our responses to previous questions, particularly to question 5.

We do not believe the TRACE academic work on transparency in the US corporate debt markets is readily applicable to the EU debate. In particular the impact that TRACE has had on transactions costs for corporate bonds in the US is unlikely to be mirrored to the same extent in the UK or Europe because we already have tighter spreads than the US and our markets tend to have greater pre-trade transparency with more dealers prepared to commit more capital in offering finer prices in larger sizes.

11. In your view, how applicable is the academic or institutional literature concerning transparency in the cash equities markets to the present discussion?

We feel that there are three key distinct differences between the relevant markets which mean that this literature cannot be relied upon by policy makers.

The first is that that while equities trade on the unique dynamics of a particular company's future prospects, bonds are generally traded within groups according to their credit rating, maturity and yield. Their price is therefore generally a much simpler mathematical calculation. Indeed, bond prices are often quoted as a spread over the yield on a risk free asset.

The second difference is that there are many more bonds than equities and that unlike equities bonds, even those issued by different issuers, can often be good substitutes for each other. In consequence, bond markets are much less concentrated than equity markets – there are some 8000 listed equities in the EU but over 200,000 bond issues in ICMA's TRAX database.

The third, and related difference, is that most investors in bonds buy and hold to maturity. Trading activity is concentrated in the first days of issue. Whereas an equity investor must deal almost exclusively in the secondary market to buy and sell a share, a bond investor can buy a bond and wait until redemption. Bonds therefore trade infrequently compared to equities. In a recent data sample, only about six non-government bonds (from a total of over 5,000 that traded on one day) experienced 200 or more trades a day. Unlike equities those six bonds will differ week by week.

One important consequence of these characteristics is that unlike cash equities there is no central or dominant pool of liquidity in bond markets, except in the most highly liquid of markets, such as certain government bonds. The academic literature on cash equity markets generally views this lack of concentration as a weakness. But because most bonds do not trade frequently, there is never a constant source of buyers and sellers looking to trade sufficient to sustain a central pool of investor provided liquidity. Investors rely on the ability of dealers, individually or collectively via telephone or e-trading systems, to assume the risk inherent in intermediating the timing differences between buyers and sellers. Liquidity is thus very dynamic and much more so in fixed-income than in equity markets. Dealers sell securities from, and buy securities into, their trading portfolios. Many such dealers provide liquidity to their clients by buying bonds from them even though they do not have and may not find an ultimate buyer to which to on-sell the bonds. Most of their trades are therefore done on an at-risk basis; i.e. they do not have both a buy and sell order at the time they enter into a transaction.

Unlike cash equities markets therefore the answer to the key question for investors, 'who is prepared to trade with me, in the bond, the quantity, and at the time I wish to trade?' is not necessarily straightforward or low cost. In practice the market has provided cost-efficient answers to those questions without regulatory pressure.

Competition to provide liquidity and attract business in Europe has motivated dealers to offer extensive and reliable pre-trade transparency through bilateral electronic systems offering firm quotes to their own clients; to participate in multilateral MTF

systems whereby clients can request competing quotes (RFQ) from several dealers simultaneously; and to have their quotes consolidated and published to the market by information vendors such as Bloomberg AllQ.

This is the model around which most dealers in bond markets are organised. Institutional investors understand that dealers act for their own account and not as an agent for them except where the institution asks for such treatment and the dealer accepts to provide it. Institutional customers rarely place orders. They ask for the price quotes of several dealers and then may decide to transact at the best price. Size is of course an important factor.

In this model an institutional investor has a considerable informational advantage over dealers since on an RFQ system (or even when calling several dealers simultaneously via telephone) only the client sees all the quotes. The competing dealers do not see each others' prices. Where trades are for a large size, the investor may wish to transact with a single dealer at a price which may be poorer than that offered by other dealers for smaller sizes. Trading immediacy for a poorer price is often accepted by an investor because the alternative would be for the market to move away from him as the first dealer tried to unwind his trade while the investor was attempting to complete the rest of his transaction.

It appears to us that this market model does not suffer from the inefficiencies and informational asymmetries which the literature on cash equities markets assumes are inherent in diversified structures not based upon central limit order book models.

12. ***What similarities and what differences are there between US and EU markets that should be borne in mind when seeking to draw inferences from the TRACE experience in the US?***

Please see our answer to question 10. Furthermore, anecdotal evidence from the US indicates that excessive transparency has lead to a reduction in capital commitment by dealers. This has created an increased competitive advantage for the larger institutional investors which are able to exert leverage on their dealers to continue to provide them with firm quotes at the expense of smaller institutions and retail brokers.

13. ***To the extent that you have identified problems or believe that others may do so, do you agree that only EU-level action would be appropriate in the present case?***

The main problem that we think needs addressing is the proper and consistent implementation of MiFID, particularly the enforcement of the new investment advice and best execution provisions. There is a need for retail investor education on bond markets, targeted to those investors who participate in bond markets on an execution-only basis.

14. ***If you have identified problems or believe that others might do so, to what extent do you consider those problems would disappear as a natural product of market evolution in the short-to-medium term?***

Apart for the issues we note in our response to question 13 we believe that market evolution is likely to continue the current trend of increasing pre-

trade and post-trade information. We discuss this issue further in the second part of our response.

15. In respect of both pre- and post-trade transparency, are the four options the right ones to consider, and in particular should other options be considered?

We believe that the four options are the appropriate ones.

16. Would you, in light of your answers to the other questions, favour any of the four options in relation to pre- and post-trade transparency (or another option you might propose for consideration) in respect of transactions in any of:

- ***Cash government bonds;***
- ***Cash investment-grade corporate bonds***
- ***Cash high-yield corporate bonds;***
- ***Asset-backed securities***
- ***Credit default swaps, interest rate swaps and bond futures;***
  Any other financial instrument you consider relevant.

As regards cash government bonds we would favour the 'no-change' option for the reasons set out above. For all other classes, if problems are identified we would favour the adoption of a self-regulatory approach to their resolution. The remainder of this response discusses the current and possible future role for self-regulation as the primary mechanism for securing fair and efficient non-equity markets in Europe.

The role of self-regulation in the European debt markets

Since the origin of the Eurobond market in Europe in 1961 self regulation has been the primary means of securing fair and efficient mechanisms for the origination, distribution and secondary market trading of what are now termed international debt securities. It is, we believe, generally recognised that the success of this market, and its now vital importance as a source of capital and repository of savings, not just for Europe but world-wide, can be attributed to the high standards which market participants have imposed upon themselves. ICMA has been and remains at the centre of the self regulatory framework. As described below, it has a unique position within Europe's bond markets as a Self Regulatory Organisation (SRO) as well as the trade association representing market participants.

ICMA as an SRO

ICMA, with the voluntary support of its members, imposes a self-regulatory framework on the trading of international debt securities between professional market participants in the EU and globally with the objective of promoting an orderly market in which investors and issues can have confidence.

In the context of the Call for Evidence several elements of that framework are significant.

1. The Association encourages those members whose business includes the activity of market making (as defined in MiFID Article 4.1.8) in international debt securities and similar activities to register as Reporting Dealers under ICMA rules. A Reporting Dealer is required, upon request, to make a price to any member of the Association with whom the reporting dealer has a

dealing relationship (as defined by ICMA) in such securities as may be agreed between the reporting dealer and the member from time to time (Rule 902.1). Reporting Dealers form a Council which currently consists of 37 investment firms.

2. On the last day of the week each reporting dealer must communicate to the Association the securities in which it will make prices in accordance with rule 902 during the following week (Rule 921).

3. At the end of each business day reporting dealers must communicate to the Association their closing bid and offer quotations for each of the securities in the list sent to the Association at the end of the previous week. (Rule 925.1)

4. Each reporting dealer is obliged to report each transaction in international debt securities to ICMA via TRAX within 30 minutes of execution – as is each UK-based member. (Rule 202.2). The rule for the members reflects the fact that the FSA applies a transaction reporting requirement to bonds.

ICMA's current contribution to pre- and post-trade transparency

A key element in an investment firm agreeing to become a Reporting Dealer is that it must consent to a significant degree of information about its activities being placed in the public domain.

After validation by ICMA an average of the bid and offer quotes for each registered security and the high, low and average prices for each international security transaction which has been reported to TRAX are published overnight as part of the ICMA Price Service. Average daily turnover for each reported security the previous month is also provided. The ICMA Price Service is available for a fee directly from ICMA or via information vendors. The identity of the reporting dealers which have contributed to each average bid/offer quote is published daily as part of the icma-info.org service.

Depending on the level of activity this data can cover up to 11,000 securities in whole or in part and can be based on 125,000 transactions a month and quotes and trade data provided by the Reporting Dealers and over 170 other members of the Association.

Annex 2 provides in tabular form key data and commentary concerning the structure of the secondary market in international debt securities derived from the TRAX database and reporting obligations of ICMA members.

The legal position of ICMA

In the United Kingdom, ICMA is approved as an 'international securities self - regulating organisation (ISSRO) under the Financial Services and Markets Act 2000. ICMA is the only organisation so approved. The UK Financial Services Authority has accorded ICMA Designated Investment Exchange status under its rules.

In 1998 the Swiss Federal Banking Commission (SFBC) recognised ICMA (then ISMA) as an institution similar to an exchange and submitted the Association in part under the Swiss Federal Stock Exchange Act (SESTA). In this capacity, and to this extent, ICMA is subject to supervision by the SFBC.

In December 1992, the European Commission issued a "comfort letter" to ICMA confirming that, based upon its examination of the rule book (i.e. the statutes, by-laws, rules and recommendations) no "grounds under article 85 (1) for further action on the part of the Commission" had been found. Following the issuance of the comfort letter by the European Commission ICMA has undertaken to ensure that any amendments to the rule book are compatible with European Union competition law. A detailed description of the status of ICMA's rule book under European competition law can be found in para. 3.1 of the attached note (see Annex 1) dated May 22, 2006 on ICMA's legal and regulatory status and relationship with regulators and organizations.

For a comprehensive exposition of ICMA's legal and regulatory status, including the organisational and reporting obligations it has assumed in order to meet its responsibilities as determined by its supervisors, also see Annex 1.

The challenge - meeting the needs of all the members and the public interest

ICMA's global membership of more than 400 firms located in some 50 countries includes major dealers in, and underwriters of, international securities in all EU Member States. As associate members it includes many governmental agencies, central banks and exchanges. But a substantial proportion of the membership consists of wealth managers, who manage client portfolios on a discretionary as well as on an advisory basis, and on a bespoke basis, tailored to the needs of an individual investor, as well as on a collective basis.

Thus the ICMA membership reflects, uniquely, the needs and interests of the buy side as well as the sell side. The challenge for ICMA when developing a policy with regard to transparency in Europe's bond markets is, as it has always been, to develop policies and rules, and secure buy-in from the members, which achieves the best balance between those needs and interests, particularly when some elements of the membership (or their regulators) perceive them to be conflicting.

The EU research

We do not intend to repeat here the conclusions which have emanated from the various independent academic and regulatory studies on Europe's bond markets which have been published in the last eighteen months.

We would however comment that so far at least it appears from these academic and official studies that the mix of self-regulation and competitive pressures, supported by major improvements in IT, which has characterised the evolution of Europe's bond markets over the last forty-five years, (at least outside the markets in domestic sovereign debt where the role of national governments as sole issuers has been the key driver), has to a very large extent met public interest goals. It has proved a powerful driver to continuous innovation in product design, trading methodologies and infrastructure. It has created a world-wide integrated market. And it has led to major improvements in the quality, quantity and timeliness of pre- and post trade information which is available free or at reasonable cost to investors and their professional advisors who choose to seek it out. It has thereby enhanced the ability of advisors to improve the quality of advice concerning bonds and the ability of investors to make, and subsequently to assess, better informed investment decisions. ICMA sees no reason why this potent mix should not continue to perform this public interest role without needing statutory intervention.

We have, however, also noted the concerns expressed by some investors in the bond market to the academic researchers and to FSA that smaller institutions and retail investors remain disadvantaged because of the difficulty and cost of acquiring relevant information about trading activity. FSA has described them as a '*small minority*' of respondents and CEPR researches noted '*except in a few cases firms tend to think the market works satisfactorily*'.

ICMA has also noted the concerns of some regulators as reflected in the May 2005 paper from IOSCO '*Strengthening Capital Markets against Financial Fraud*' that lack of transparency may have aggravated the losses of retail investors in some recent corporate defaults.

We have reservations about both these concerns. As FSA has noted, there are many reasons why retail investors in the UK do not often choose to invest in bonds and we share its conclusion that *'the lack of availability of transparency information does not appear to be a major factor and we doubt that enhanced transparency would increase retail participation significantly'*. As for smaller fund management entities we note that many of the most innovative and aggressive bond market investment strategies originate in these firms, both within and outside the hedge fund fraternity, which implies that that those who value information can acquire it, and profit by it, if they are prepared to use the effort and resources required.

With regard to the losses suffered by retail investors in Parmalat, Cirio etc., which were, at their core, failures of corporate governance and audit in the issuers, our suspicion is that a contributing factor may have been the quality of investment advice offered to retail investors rather than insufficient transparency in secondary market trading. We therefore very much welcome the inclusion of investment advice as a core activity in MiFID. More comprehensive obligations on firms to properly identify and manage conflicts of interest should also lead to improvements here.

The way forward

These reservations notwithstanding, as an SRO, ICMA, in consultation with its members, is constantly examining its own rules, recommendations, procedures and the services it offers to its members and market users and participants more generally. In the last two years, for example, ICMA introduced icma.org which provides easy access for subscribers to the over 20 year of data on Europe's bond markets including secondary market data and prospectuses of over 200,000 issues. This year it has rolled out substantial improvements to TRAX, designed in particular to respond to the clear market need for more efficient clearing, settlement and post-trade management in the rapidly expanding repurchase agreement market, daily volume in which substantially exceed volumes in the cash market for bonds.

We have also been discussing the issues concerning bond market transparency for some time with our liquidity providers and have now extended that process to our buy-side members to establish whether, in their view, there is more that can and should be done at the self-regulatory level to further enhance the levels of post-trade transparency in international debt securities. We will also hold discussions with other representative associations from the fund management community. ICMA is committed to pursuing this work with an open mind as to the eventual outcome. We seek to make a positive contribution to the debate and to do so, on the basis of securing as great a degree of

consensus as possible among the diversity of interests reflected in ICMA's membership.

We will return to the Commission early in 2007, with our conclusions which we believe will have the support of a critical mass of buy side and sell side participants in Europe's bond markets. We will then be anxious to engage in substantive dialogue concerning the self-regulatory option. In particular, assuming we proceed with phased or experimental introduction of enhanced transparency, we would welcome close cooperation with and advice from the Commission and CESR, and indeed the academic community, on the details of our plans, their relevance to the appropriate regime for best execution in dealer markets and on how to assess whether there are any adverse effects on liquidity.

In conclusion, ICMA welcomes the fact that the Commission is fully cognisant of the need to ensure that if the evolution of Europe's bond markets are to continue to be one of the main drivers of economic growth and the underpinning of secure long term savings, it will be essential to ensure that, to the greatest extent possible, any changes in the rules governing their operation are driven by and are consistent with the needs of all market participants.

ICMA
September 15, 2006

Annex 1

ICMA's legal and regulatory status and relationship with regulators and organisations

[See enclosed ICMA paper]

Annex 2

Secondary market trading in debt securities in the EU[2]

Total number of bonds

The universe of bond issues contained in the ICMA database as at June 21, 2005 was as follows:

Bond type	International	Domestic	Total
Straight issues	99,835	21,727	121,562
FRNs	69,943	5,905	75,848
Convertible	2,078	1,352	3,430
Total	171,856	28,984	200,840

Number of Reporting Dealers (Market Makers)

As at June 17, 2005 members of the ICMA Council of Reporting Dealers contributed indicative bid/offered quotations on a total of 9,406 issues as follows:

Number of dealers per issue	Number of issues
one	2,198
2-5	4,307
6-9	1,788
10 +	1,113

Number of trades per day

On June 3, 2005, which appeared to be a fairly typical day, a total of 5,273 bonds (using single counting and excluding all repos and domestic government issues) were traded generating a total of 24,691 trades. Further analysis produced the following results:

Number of trades	Number of issues
one	1,891
2-3	1,713
4-9	1,197
10-49	434
50-99	25
100-199	7
200-299	3
300-399	2
400-499	1

Statistics as supplied to FSA for its Discussion Paper DP05/5 'Trading transparency in the UK Secondary Bond markets'

Dispersion of trades by size

Again this analysis was made on the trade data of June 3, 2005 and split into the 3 major currencies together with the aggregate of the remaining currencies.

Trade size	EUR	USD	GBP	Other
5m +	1,163	667	218	98
2-4.999m	1,142	1,256	265	97
1-1.999m	1,194	1,167	290	136
0.5-0.999m	941	1,104	246	199
0.25-0.499m	754	897	284	170
0.1-0.249m	1,536	1,205	327	318
0.05-0.999m	1,040	1,063	227	359
Below 0.05m	2,203	2,271	735	1,119
Total	9,973	9,630	2,592	2,496
Average trade size	1,587,353	1,794,931	1,962,042	1,087,710
Median trade size	100,000	349,478	255,693	60,755

Bond trades in 30-day period

During the 30-day online period from May 18 to June 28 (to approximately 14:00 hours) a total of 21,900 separate bond issues were traded, which total may be classified as follows:

Currency	Number of issues
USD	8,654
EUR	7,833
GBP	1,733
JPY	914
AUD	649
CHF	334
CAD	302
ZAR	190
HKD	150
NZD	144
All other	527
Legacy	470

Analysis by number of trades (percentages in brackets)

2203 (22%) < €50K < 7770 (78%)

Analysis by total value of trades (rounded to nearest million) (percentages of total in brackets)

€88 million (0.6%) < €50K < €14.7 billion

Key facts:

On this randomly selected day less than 25% of trades by number were of a trade size less than of €50,000.

The value of these ‘small' trades was significantly less than 1% of the total.

Average trade size in excess of €1.5 million

Commentary

It is interesting to note that that over 35% of the trades by number were for amounts in excess of €1 million and 12% were for amounts in excess of €5 million. There were more trades for amounts in excess of €2 million than there were for amounts of less than €50,000.

In comparison, the report on TRACE trading quoted in the May 2004 IOSCO report on Corporate Bond Market Transparency states that trades for an amount of less than $100,000 account for less than 2% of total value but 65% of trades by number. Although not directly comparable, the Eurobond market appears far more dominated by institutional investors.

It is doubtful whether $100,000 or €50,000 are realistic breakpoints for retail v professional investors. MiFID has adopted a figure of €7500 for the size of order in equities customarily undertaken by a retail investor. It is unlikely that the number would be substantially larger for bonds. If €7500 was used in the analysis it would skew the TRAX and TRACE figures even further towards the institutional end of the market.

One note of caution: the data is comprehensive as far as the wholesale market is concerned. All ICMA reporting dealers (market makers) must use TRAX as must all ICMA members in the UK. It thus represents most of the process by which retail oriented European banks acquire bonds for their clients and dispose of them if they cannot match sell orders in house. It does not include the internal process in these banks of breaking up blocks of new issues and selling them to retail clients via their branch networks.

Equity market comparisons[3]

Key facts:

- Average trade size is much lower in equities than in bonds.
- Number of trades per day is much lower in bonds than in equities

Examples

Euronext

Trades below €50k are 86% by number of trades (22% TRAX) and 30% by value (< 1% TRAX)

Average trade size €30k (€1.5 million plus TRAX)

[3] Various sources

London Stock Exchange

SETS average trade size = €30K

All UK equities average trade size = €66K

International equities average trade size (largely professional market) = €200K

These average trade sizes have been declining in recent years. The general consensus is that this decline does not reflect an increase in direct retail investment in equities but instead reflects the growth of tracker funds and hedge funds. The latter often employ trading models which route vast numbers of small orders to central limit order books, often via Direct Market Access computer links.

MiFID definition of a liquid share

MiFID (level 2 Regulation Article 22) sets two criteria for determining liquid shares for the purposes of establishing the list of those shares subject to the systematic internalisation continuous quoting provisions. These are

- Average daily number of transactions in the share is not less than 500
- The average daily turnover for the share is not less than €2 million

Based on the TRAX data above, on that particular day no bond would have met the first criterion and although several would have met the second criterion that would probably have been in less than 10 trades. Furthermore, liquidity, defined as a high daily turnover level, is generally concentrated in the first few days pre- and post-issue. Following that period, during which the bonds are distributed to long-term holders, volumes for most bonds decline to, or close to, zero on a daily average basis.

ICMA's Legal and Regulatory Status and Relationship with Regulators and Organisations

1. LEGAL STATUS IN SWITZERLAND

1.1 Association under Swiss law

ICMA was established in 1969 as an association ("Verein") founded under the laws of Switzerland with independent legal capacity. It is registered in the Commercial Register of the Canton of Zurich.

1.2 Institution similar to an exchange

Until October 1998 ICMA was not subject to supervision in Switzerland. The Federal Act on Stock Exchanges and Securities Trading (***SESTA***) which came into force in February 1997/January 1998 introduced the concept of an institution similar to an exchange ("*börsenähnliche Einrichtung*"). In its decision of October 28, 1998 (the ***Decision***), the Swiss Federal Banking Commission (the ***SFBC***) ruled that ICMA is such an institution and therefore submitted ICMA in part under SESTA and in this capacity and to this extent under its supervision.

Pursuant to the Decision the SFBC granted ICMA a licence to operate as an institution similar to an exchange and approved ICMA's statutes and by-laws. The Decision also sets out a number of requirements with which ICMA must comply in order to maintain its authorisation. These requirements are outlined in the bullet points below.

- Pursuant to the Decision ICMA had to institute an internal supervisory body responsible for the supervision of transactions reported to ICMA's transaction matching, confirmation and reporting system (***TRAX***) comprising the Chief Executive and two other board members. The regulations of this body (the ***TRAX Supervisory Committee***) were submitted to, and approved by, the SFBC on March 25, 1999. The composition of the TRAX Supervisory Committee is subject to approval by the SFBC.

- ICMA must inform the SFBC if it receives indications of or suspects any violations of law or other gross improprieties, such as violations of ICMA's statutes, by-laws or rules and recommendations committed by a member.

- ICMA must provide for the keeping of international securities transaction records as a membership requirement where no

corresponding obligation exists in the member's place of business.

- Pursuant to the Decision any amendments made to ICMA's statutes and by-laws and any changes to its organisation, management and board after October 28, 1998 must be reported to the SFBC. Any amendments made to by-laws 501 to 560 concerning disciplinary proceedings are subject to the SFBC's prior approval.

- Quarterly reports must be submitted to the SFBC on newly admitted members (including their competent supervisory authority) and on newly admitted TRAX subscribers (including their competent supervisory authority).

- ICMA must provide the SFBC with bi-annual updated lists of members and TRAX subscribers.

- ICMA must inform the SFBC of any proceedings against members before the agencies of the Association and of expulsions and rejections of applications for membership.

- ICMA must provide the SFBC with quarterly statistical evaluations on the transactions reported to TRAX.

- In addition, ICMA's auditors must report annually in writing to the SFBC with their views on the activity of ICMA and on ICMA's compliance with the SFBC requirements detailed in the Decision. The report must be filed on March 31. Subsequent to the Decision, the SFBC confirmed to ICMA's auditors that based on justifiable grounds this deadline could be extended to expire no later than June 30 of each year.

On July 1, 2005, the International Primary Market Association (IPMA) transferred its assets, liabilities and activities to ISMA and ISMA changed its name to International Capital Market Association (ICMA). The SFBC confirmed that this merger does not affect ICMA's status under SESTA.

2. LEGAL STATUS IN THE UK

2.1 THE FINANCIAL SERVICES AND MARKETS ACT 2000

2.1.1 Introduction

The Financial Services and Markets Act 2000 (the ***FSMA***) and secondary legislation made under it provide the basis for the regulation of the banking, insurance and investment services

industries in the UK[1]. Under the FSMA a statutory single regulatory authority, the Financial Services Authority (the ***FSA***), is responsible for the supervision of these industries. The FSA has published a Handbook of Rules and Guidance under its rule-making powers in the FSMA. The rules provide a detailed set of provisions applying to authorised persons, such as prudential requirements and conduct of business rules.

Under the FSMA regime, investments include stocks and shares, debentures, government and other public securities, warrants to subscribe for shares or bonds, futures, contracts for differences, options to acquire or dispose of any such securities and depositary receipts. The activities which are regulated under the FSMA include dealing in investments, managing investments, advising on investments and establishing collective investment schemes such as UCITS[2] and OEICs[3]. They also include making "arrangements with a view to another person buying, selling, subscribing for or underwriting a particular investment" (Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (the ***RAO***), Article 25). This covers the activities of an investment exchange.

Section 19 of the FSMA prohibits any person from carrying on a regulated activity in the UK unless he is either an authorised person or an exempted person. This is known as the general prohibition. ICMA's operation of the TRAX trade matching and confirmation system (through the agency of International Capital Market Association Limited (***ICMA Limited)*** pursuant to the terms of a Service Agreement dated July 17, 1992) amounts to the carrying on of a regulated activity for the purposes of the FSMA because it serves to facilitate deals in investments and is therefore arranging for the purposes of Article 25 of the RAO. Accordingly, ICMA and ICMA Limited need to have a status in the UK which enable them to carry on regulated activities without being authorised under the FSMA.

2.1.2 Recognised Investment Exchange

Section 285(2) of the FSMA provides that a Recognised Investment Exchange (***RIE***) is exempt from the general prohibition if it carries on a regulated activity as part of its business as an investment exchange, or it is carried on for the purposes of, or in connection

[1] The FSMA, which came into force at midnight on November 30, 2001 (known as N2), replaced the Financial Services Act 1986. The FSMA established the FSA which has taken over the functions of the self-regulating organisations such as The Securities and Futures Authority (SFA), which have ceased to exist.

[2] Undertaking for Collective Investment in Transferable Securities

[3] Open Ended Investment Company

with, the provision of clearing services by the exchange (Section 285(2)).

The objective of recognising investment exchanges is to ensure that they are exempted persons for the purposes of carrying on regulated activities and to encourage transactions in investments to take place on an exchange rather than "off-exchange".

The Treasury have set down in the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001 recognition requirements which must be satisfied on a continuous basis if an entity is to be recognised, and continue to be recognised, as an investment exchange. These requirements are wide in scope and include matters such as adequate financial resources, suitability, systems and controls, safeguards for investors, discipline and default. The FSA has the power to revoke the recognition of an exchange if it fails to comply with the recognition requirements. A list of the existing RIEs is attached to this note (attachment 1).

2.1.3 Recognised Overseas Investment Exchange

The FSMA also contains a regime for exchanges which have their head offices outside the UK but which carry on regulated activities in the UK. Such exchanges are known as Recognised Overseas Investment Exchanges (***ROIEs***) which must obtain recognition from the FSA under section 292 of the FSMA. In order for a body to be eligible for recognition as an ROIE, it must be able to demonstrate that (i) it is, in the country in which its head office is situated, subject to supervision which, together with the rules and practices of that body, is such that investors in the UK are afforded protection at least equivalent to that provided by the provisions of the FSMA in relation to RIEs; (ii) that there are adequate procedures for dealing with a person who is unable, or likely to become unable, to meet his obligations in respect of one or more market contracts connected with the investment exchange; (iii) that it is able and willing to co-operate with the FSA; and (iv) that adequate arrangements exist for co-operation between the home supervisors of that body and the FSA.

ICMA is not currently eligible to qualify as an ROIE because it does not satisfy condition (i) referred to above. Although ICMA is subject to partial supervision in Switzerland, this, together with ICMA’s rules, is not such that investors in the UK are afforded protection at least equivalent to that provided by the provisions of the FSMA in relation to RIEs. However, if ICMA were to become subject to a higher degree of supervision in Switzerland in the future it might then satisfy this condition.

ICMA's rules do not contain provisions relating to the default of a member, and so the second condition is not satisfied.

There has been some concern that direct disclosure of information by ICMA to foreign regulators without the consent of the person involved is severely curtailed by the Swiss secrecy laws to which it is subject and therefore condition (iii) might not be satisfied. However, there exists a Memorandum of Understanding between the UK and Switzerland dated October 30, 1991 (which is supplemented by an exchange of correspondence between the FSA and the SFBC in 1999) providing for the exchange of information between the respective regulatory authorities. Information which may be required to be divulged to Swiss regulators may then be passed on by those authorities to foreign regulators without infringement of the secrecy laws by ICMA. The third condition referred to above therefore appears to be satisfied. The existence of the Memorandum of Understanding also means that the fourth condition referred to above is satisfied.

A list of the existing ROIEs is attached to this note (attachment 2).

2.1.4 International Securities Self-Regulating Organisation

ICMA is approved as an "international securities self-regulating organisation" (***ISSRO***) for the purposes of Article 35 of the RAO[4]. This designation was specially created for ICMA which, as explained above, could not satisfy the conditions for eligibility as an ROIE. ICMA's approval as an ISSRO is dependent on it remaining ineligible to qualify as an ROIE by reason of it not being able to satisfy either or both of conditions (i) or (ii) referred to above (see Article 35(3)(b) of the RAO); should ICMA at any stage be able to satisfy both these conditions then ISSRO status would no longer be available to it. However, the Treasury, which are now responsible for approval of ICMA as an ISSRO, have indicated that regulation in Switzerland would not necessarily mean that ICMA would have to relinquish its ISSRO status.

As an ISSRO, ICMA's and ICMA Limited's activities of arranging deals in investments (whether through the activities of TRAX or otherwise) are excluded from the regulated activity of arranging for the purposes of the FSMA. The understanding on which ICMA's original approval as an ISSRO was granted was that the reporting of equity trades through TRAX would remain "de minimis and peripheral" to its overall use as a system for the reporting of international securities by its members (see letter from the DTI to ICMA dated April 7, 1988).

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[4] ICMA was originally approved by the Department of Trade and Industry under paragraph 25B of Schedule 1 to the Financial Services Act 1986.

ICMA is the only body to be accorded ISSRO status.

ICMA's regulatory obligations as an ISSRO are relatively light and essentially involve its having to provide the Treasury with monthly information concerning details of trades involving international securities entered into by members who are UK authorised persons. The information provided does not include information about counterparties or any other information that could identify counterparties.

As an ISSRO, ICMA may only have a membership composed of persons who are either authorised or exempted persons for the purposes of the FSMA or otherwise whose head office is located outside the UK and whose ordinary business involves them in engaging in activities which are activities of a kind specified by the RAO.

HM Treasury confirmed that the merger between ISMA and IPMA which took effect on July 1, 2005 does not affect ICMA's status as an ISSRO.

2.1.5 Designated Investment Exchange

The FSA, for the purposes of its Conduct of Business Rules (and also its regulatory capital rules), created a special category of exchange known as a Designated Investment Exchange (***DIE***). ICMA has been designated as a DIE. Designation by the FSA means that transactions on the relevant exchanges are more favourably treated for the purposes of the relevant FSA rules; for example, instruments traded on DIEs benefit from a more favourable capital adequacy treatment than instruments traded off-exchange. A list of the existing DIEs designated by the FSA is attached to this note (attachment 3).

While an RIE is an exempted person for the purposes of the FSMA by reason of its designation, a DIE is accorded its status by virtue of the particular application of the rules of the FSA and it is only through the detailed application of those rules that the consequences of having DIE status can be ascertained.

The FSA confirmed that the merger between ISMA and IPMA which took effect on July 1, 2005 does not affect ICMA's status as a DIE.

2.1.6 Status of TRAX: approved reporting system

The rules of the FSA contain provisions requiring the reporting of transactions for audit trail purposes. The FSA requires that

transaction reporting be made through one of the reporting systems listed in its Supervision Manual[5] (SUP 17.7.8R).

Under ICMA Rule 202.1, members who carry on investment business in the UK and who are subject to a requirement to report transactions in international securities [under the rules of a self-regulatory organisation recognised under the Financial Services Act 1986 or any act which replaces that act] are obliged to report to ICMA every transaction in international securities whether or not entered into with another ICMA member. TRAX is one of the systems approved under SUP17.7.8R for the purposes of the FSA's rules. Accordingly, by reporting through TRAX, UK-based members of ICMA are able to satisfy their transaction reporting obligation to FSA. In October 1994, ICMA entered into a Memorandum of Understanding with SFA under which it agreed to supply SFA with daily details of all transactions reported to it by its members.

Under SUP17.6.2(3)R and SUP17 Ann 2R regulated firms are required to identify the relevant counterparty by reference to an identifying code, as well as provide various other pieces of information relating to the transaction. Although the TRAX General Terms and Conditions impose upon ICMA a duty of confidentiality in respect of information reported through TRAX, there is an exemption for information which is required to be disclosed under any applicable law or regulation and in the performance of the transaction reporting function of TRAX[6]. There is a similar exemption for information which is required to be disclosed under the regulations of any relevant stock exchange. Accordingly, ICMA is not in breach of the duty of confidentiality by including the identity of the counterparty in the information passed to the FSA or a relevant stock exchange.

2.1.7 Price Stabilisation

The FSA's price stabilisation rules provide a safe harbour, for stabilising activities carried out in accordance with those rules, from the offences of insider dealing under the Criminal Justice Act 1993, making misleading statements under Section 397 of the FSMA and the civil offences under the FSMA's market abuse regime. The price stabilisation rules will apply to securities which are, or may be, traded under ICMA's rules (MAR 2.2.1(2)(c)R).

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[5] The Supervision Manual forms part of the FSA's Handbook of Rules and Guidance.

[6] TRAX General Terms and Conditions, Condition 8.1 and 8.3.1.

3. RELATIONSHIP WITH OTHER REGULATORS AND ORGANISATIONS

3.1 European Commission

ICMA applied to the European Commission in March 1990 for negative clearance of, and notified for exemption, its statutes, by-laws, rules and recommendations. By a letter dated December 16, 1992, the EC Commission indicated that their examination of ICMA's Rule Book did not reveal the existence of any grounds under Article 85(1) of the Treaty of Rome for further action on the part of the Commission. This "comfort letter" from the Commission is confirmation by the Commission that the present ICMA Rule Book is compatible with Community Competition Law. Pursuant to an agreement reached with the Commission at that time, ICMA has notified the Commission of subsequent changes to its Rule Book and has obtained confirmation (in letters dated September 3, 1997 and November 18, 1997) that changes to the definition of “reporting dealer” and to the by-laws on suspension of membership and disciplinary proceedings did not seem to comprise an appreciable restriction of competition.

In a letter dated January 31, 2002, the Commission confirmed that ICMA no longer needs to consult informally with the Commission in relation to envisaged changes to its Rule Book which it considers might raise competition concerns for the Commission, but that ICMA is free to notify the Commission of proposed amendments if it considers it necessary to do so. As from February 1, 2002, any amendment proposed to ICMA’s Rule Book (including the amendment to incorporate IPMA’s Handbook) is forwarded to Freshfields Bruckhaus Deringer for advice on whether such amendments need to be notified to the Commission.

3.2 Office of Fair Trading

Under the Restrictive Trade Practices Act 1976 (the ***RTPA)*** ICMA filed with the OFT its statutes, by-laws, rules and recommendations and, as a matter of course and on a fail-safe basis, delivered to it any amendments of the Rule Book for clearance. On March 1, 2000 the RTPA was replaced by the Competition Act 1998 (the ***Competition Act***) and there is no longer any provision for furnishing amendments to agreements registered under the RTPA. The historic exemption for ICMA’s Rule Book will however continue in the absence of material amendments to it. From the coming into force of the Competition Act, any amendments proposed to ICMA’s Rule Book (including the amendment to incorporate IPMA’s Handbook) are forwarded to Freshfields Bruckhaus Deringer for advice on whether the materiality test is likely to be met and whether

such amendments should be forwarded to the OFT for guidance or a decision on whether it infringes the Competition Act.

3.3 IOSCO

ICMA is an affiliate member of International Organisation of Securities Commissions (IOSCO) and in consequence a member of the IOSCO SRO Consultative Committee. In connection with its membership of the SRO Consultative Committee, ICMA has given an undertaking to provide assistance on a reciprocal basis, to the extent permitted by law, towards self-regulatory organisations, that are also members of the SRO Consultative Committee and who have signed a similar undertaking. This undertaking has been given by ICMA in the light of a resolution by the members of the SRO Consultative Committee on information sharing between the SROs that are included in its membership.

3.4 ICSA

ICMA is a member of the International Council of Securities Associations, comprising a number of important trade associations and non-governmental regulatory organisations.

July 12, 2005/TH/ch

Attachments

Attachment 1

RECOGNISED INVESTMENT EXCHANGES

EDX London Ltd
131 Finsbury Pavement
London EC2A 1NT

The International Petroleum Exchange of London Limited
International House
1 St. Katharine's Way
London E1W 1UY

London Stock Exchange plc
10 Paternoster Square
London EC4M 7LS

LIFFE Administration and Management
Cannon Bridge House
1 Cousin Lane
London EC4R 3XX

The London Metal Exchange Limited
56 Leadenhall Street
London EC3A 2BJ

virt-x Exchange Limited
One Canada Square
34th Floor
Canary Wharf
London E14 5AA

Attachment 2

RECOGNISED OVERSEAS INVESTMENT EXCHANGES

National Association of Securities Dealers Automated Quotations (NASDAQ)

Sydney Futures Exchange Limited

The Chicago Mercantile Exchange (CME)

Chicago Board of Trade (CBOT)

New York Mercantile Exchange Inc. (NYMEX Inc.)

The Swiss Stock Exchange (SWX)

Cantor Financial Futures Exchange (CFEE)

EUREX (Zurich)

Warenterminborse Hannover

NQLX LLC

US Futures Exchange LLC

Attachment 3

DESIGNATED INVESTMENT EXCHANGES

American Stock Exchange
Australian Stock Exchange

Bermuda Stock Exchange
Bolsa Mexicana de Valores
Bourse de Montreal Inc.

Channel Islands Stock Exchange
Chicago Board of Trade
Chicago Board Options Exchange
Chicago Stock Exchange
Coffee, Sugar and Cocoa Exchange, Inc.

Euronext Amsterdam Commodities Market

Hong Kong Exchanges and Clearing Limited

International Capital Market Association

Johannesburg Stock Exchange

Kansas City Board of Trade
Korea Stock Exchange

MidAmerica Commodity Exchange
Minneapolis Grain Exchange

New York Cotton Exchange
New York Futures Exchange
New York Stock Exchange
New Zealand Stock Exchange

Osaka Securities Exchange

Pacific Exchange
Philadelphia Stock Exchange

Singapore Exchange
South African Futures Exchange

Tokyo International Financial Futures Exchange
Tokyo Stock Exchange
Toronto Stock Exchange