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

EuroInvestors RESPONSE
04/06/2010

EuroInvestors (the European Federation of Investors or EFI) was created in the summer of 2009, following the financial crisis which demonstrated the limits of the almost exclusive dialogue between regulators and the financial industry, largely ignoring the user side. EFI aims at representing and defending at the European level the interests of financial services users in order to promote training, research and information on investments, savings, borrowings and Personal Finances of individuals in Europe, by grouping the organisations pursuing the same objectives at a national or international level. Already about 45 national organizations of investors and other financial services users have joined us, and EFI already represents about two million European citizens.

Preliminary remarks

This consultation is tailored to market professionals and institutional investors, not to individual investors. The deadline is very short: this consultation was posted on CESR's web site on May 7 for a reply by June 4, i.e. less than a month. This does not take into account the very limited resources of individual investors' representatives, especially compared to market professionals who have full teams paid and dedicated to do that.

In addition, EuroInvestors already had to respond to two concurring CESR consultations on Investor Protection & Intermediaries, and on secondary equity markets.

Finally, contrary to the previous CESR consultation on this issue, there is no questionnaire tailored to retail investors (questions identified as "*particularly relevant to representatives of Retail Investor Associations*") this time.

For these reasons, we will stress only three points:

1. **The urgent and crucial need to increase pre- and post trade transparency of fixed income products sold extensively to retail investors.**

With the remarkable exception of Italy, retail investors have been largely driven out of the bond markets in the last three decades due to the "re intermediation" of capital markets at the expense of end investors and issuers and to the benefit of financial intermediaries. It is indeed much more profitable for those intermediaries to sell "packaged" fixed income products such as funds or

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unit-linked insurance products for third party issuers, and home made EMTNs, rather than straight bond issues as it was the widespread case in the past . The supervisors have done nothing to stop or limit this trend. Actually, MiFID is only accelerating it if anything.

Recently though, due to the drop of interest rates on other some other retail investment products (such as savings accounts for example), quite a few bond issues have been sold directly again to retail investors:

- Bonds from large corporate issuers
- Bank EMTNs sold at the bank's counters.

We have for example evidence of a bank EMTN series sold at 102 % of issue value at the counter, when , at the same time it was quoting 85 to 90 on the "regulated" secondary market (Luxembourg Exchange in that case). The instant profit for the bank on the back of the retail client was therefore 17 %. Of course – supposing they knew about it, which they did not - it was nearly impossible for retail investors to find such quotes (see point 3 below), and even more difficult to make any retail trade on this issue.

2. The need to ensure a minimum liquidity of these fixed income securities sold to retail investors on the secondary market

This can be achieved through "market making" agreements between the issuers and fixed income market professionals, like it is routinely done for the secondary market of ETFs (including fixed income ETFs), in particular by guaranteeing a maximum bid/offer spread.

3. The need to recall FIN-USE's responses to the previous CESR consultation on non equity transparency (March 2009)[1].

Indeed, these responses are still valid as they clearly demonstrate the lack of real pre and post trade transparency for bond despite the former promises of the industry:

"This consultation does not include any analysis or questions on the impact of the major fixed income markets failure in 2008 on equity markets. FIN-USE believes many institutions which needed cash in 2008 (for example hedge funds) could not unload their fixed income securities because of the failure of these markets, and therefore unloaded part or all of their equity portfolios as the equity markets remained the only ones open and liquid. This would have of course played a significant role in the collapse of equity prices last year. It seems the regulated equities markets are a victim of their exemplarity. FIN-USE believes this is an important issue that should be thoroughly investigated by the financial regulators. The objectives of CESR on bonds markets transparency do not address the problem properly. It is only focussing on industry sustainability. Bonds markets need a new structure. The question would then be whether the fixed income markets should be regulated as the main equity ones.

"Questions particularly relevant to representatives of Retail Investor Associations:"

[1] http://ec.europa.eu/internal_market/fin-use_forum/docs/non-equity_transparency_en.pdf

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1. To what extent can corporate bond markets be characterized as wholesale or retail markets? How would you distinguish between wholesale and retail markets? What are the differences across the EU? (Question 22 of the consultation paper)

Obviously the bond markets are de facto wholesale, not retail (except in Italy and partially in Spain). A retail market is a market where individual investors play a significant role, even if it is much smaller than other participants'. Contrary to regulated equity markets in the EU, it is extremely difficult for individual investors to buy and sell bonds. We have many examples of even sophisticated and financially educated individual investors who do not know how to buy bonds. There are cases of redistributions of bonds issues between retail investors that must be addressed.

2. What would be the potential benefits and downsides of a harmonised pan-European transparency regime for the retail market? Would greater post-trade transparency for example attract retail investors more? (Question 23 of the consultation paper)

Currently (except in Italy) there is no pre or post-trade transparency for retail investors. See Annex 1 for an example of the practical impossibility for a French individual investor to get basic trading information on a given bond issue. This annex also shows an alternative choice recently provided by insurers to individual investors to indirectly access the corporate bond market. But this indirect access is for the happy fews ("good" clients who will invest a minimum of € 10 000) and is not submitted to any of MiFID rules; especially in terms of best execution, information, advice and inducements. Pricing is also an issue.

This example shows that there is demand for bonds, and obviously individual investors would come to this market if it provided the same transparency as the equities markets, which are trading much more risky assets, and where they are active participants.

Another benefit of direct access to the bond markets (this includes the biggest one – the government and public agencies market as pointed out in our preliminary remarks) would be a potential for better performance than indirect access. Currently this indirect access is provided mainly by bond investment funds. Their performances have been on average very much below the ones of their relevant markets. For example, Bond funds in French corporate savings plans have returned 3,3% per year on average over eight years (1999-2006) versus 4,6% for the bond market[2]. And the situation is getting worst for bond funds investors as access to quality funds becomes more difficult and more costly (see annex 2: recent release from a major bond fund manager).

Also, CESR did not address in his consultation paper the indirect but severe damage to retail investors of the fixed income markets failures, especially in the money market funds area, when asset-backed securities markets actually shut down, eliminating any liquidity and fair pricing of many of these funds underlying assets. Even to-day, the valuation of bond funds and of bond portfolios indirectly held by retail investors (life insurance funds for example) is questionable. We also mentioned in our preliminary remarks the indirect damage done to the equities markets prices by the fixed income markets failure.

This means individual investors are penalized by the inaccessibility of bond markets, mainly due to their lack of transparency.

[2] Source : AFG, Europerformance, 2007 ; the bond market performance is measured by the Lehman Euro Aggregate Government Bond Index.

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There are also cases of redistributions of bonds issues between retail investors that have produced severe damages to them (Lehman bonds, Iceland Banks Preferred Notes). In many cases, they have not received proper information on market value of their investments.

3. Do you believe that better post-trade transparency could improve the efficiency of the price discovery process, reducing bid-ask spreads and search costs for investors and fostering competition among dealers? (Question 13 of the consultation paper)

Obviously yes, as, again, it is actually non existent currently for individual investors in most Member States. The consultation paper does not actually analyze or give any data on the widening of bid-offer spreads. This is unfortunate and may be coming from a difficulty in getting the quantitative data for CESR itself. Quantitative measures would probably show huge bid-offer spreads. Also, this relates to a well-known behavior in the bond dealers world: fronting. Bond dealers will often “front” a trade with an investor to make a large profit later on selling it to another. The introduction of pre and post trade transparency at the retail level (as it exists in the equities markets) would most certainly reduce dealers’ margins. This most probably is one reason they fight it and argue that it would reduce liquidity. This is very unlikely. First because the current liquidity of bond markets is still appallingly low (see annex 2). Second because the much more transparent equities markets are also much more liquid.

The move by the Italian public authorities to apply all MiFID provisions to the Italian bond market is positive and a generalization to all member states should be carefully considered by CESR (see annex 3 on the situation in Italy).

4. Would additional post-trade transparency help investment firms to comply with MiFID requirements intended to enhance investor protection, such as information disclosure to clients, suitability assessments and providing best execution to investors? (Question 13 of the consultation paper)

Yes, definitely. Right now it is very difficult to assess best execution at the retail level. Also, as previously mentioned, best execution and other MiFID requirements do not apply to bond issues sold to individual investors packaged as units in insurance contracts (see annex 1). We are surprised that CESR does not mention also the MifID inducements, which aim at protecting retail investors against conflicts of interests at the distribution level.

5. Do you think that greater post-trade transparency could have a negative impact on liquidity? Or do you think that it could have any other drawbacks which CESR needs to consider? (Questions 13 and 14 of the consultation paper).

None, see our replies to Q3 and 4. We believe on the contrary that pre and post trade transparency at the retail level would improve liquidity, which, again, is almost non-existent nowadays (see annex 2). Again, the example of the equities markets clearly shows that more transparency and regulation only thoroughly increase liquidity.

6. Please provide information on your experience, if any, in terms of timing, content and access to information of the market-led solutions such as those of ICMA or SIFMA. What is your

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assessment of the effectiveness of the present self-regulatory initiatives? (Question 18 of the consultation paper)

As one can see through the example detailed in annex 1, there seems to be no effectiveness of ICMA and SIFMA "solutions" at the retail level. Again transparency at that level seems actually non existent (except in Italy). Self-regulations are facing their limits here, as elsewhere in the financial industry.

7. What would be the most cost-effective way of delivering additional transparency for the retail market: an industry-led solution, possibly based on a road map set by regulators, or mandatory regulatory post-trade transparency requirements? (Question 26 of the consultation paper)

Self –regulation has again shown its limits, not to say its failure in this area. As the Italian Government already concluded, mandatory regulation is needed quickly and again not only on post trade transparency, but also on pre-trade transparency.

8. Do you think that the introduction of additional post-trade information on prices could help restore market confidence and maintain market liquidity in times of future crisis? (Question 20 of the consultation paper)

It is going to take time to restore a badly damaged confidence and liquidity, but pre and post trade transparency at the retail level is certainly a badly needed pre-requisite. Everyone needs to see better what is happening on the fixed income markets. The only way is to provide an equivalent level of retail transparency as for the equities markets. Again, EC equities markets remained opened and liquid through even the toughest times of the 2008 financial crisis, contrary to the fixed income markets. On clear reason is the transparency of these markets operations, and their retail investor-friendly features, which are missing for fixed income.

9. Regarding structured finance products and credit derivatives, what post-trade information should be published? In addition to information about the price at which the transaction was executed, the volume and the time of the transaction, would there be any benefit in publishing information about portfolio composition, asset class, the initial interest (seller or buyer)? Is there any other information which would be relevant? When should post-trade information be published? Should it be published immediately after a trade has been concluded? (Questions 35 , 36, 44 and 45 of the consultation paper)

These markets are not accessible to individual investors, but they are indirectly exposed as fixed income funds and money market funds (at least up to 2007) were heavily invested in these products, especially asset-backed securities. Markets for asset-backed securities virtually shut down through part of 2007 and 2008. This created very serious liquidity issues for investment funds as well as valuation issues. These are markets that are too complex for retail investors (one could question if they are not too complex for the financial professionals as well when one sees how they handled them for the last two years) and should remain in the hands of professional

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participants, but at their own risk and responsibility, not to unload them to individual investors through investment funds (UCITS) or other retail collective instruments.

Individual investors who are affluent and/or financially educated should be able to buy bonds on the market, as easily as they can buy equities. The others should be able to participate in retail collective bond instruments really invested in bonds, excluding complex and inaccessible products: back to simplicity. The crisis has proven that the financial industry, the rating agencies and the auditors have not been able to master these asset-backed securities and credit derivatives themselves. Why unload them to individuals?"

ANNEX 1

Retail corporate bond market transparency example

(Vodafone Group 6,875 % 12/2008)

December 2008, a French retail investor gets an offer to invest in this corporate bond from his online insurance broker, with a net yield of 6,035% (because of yearly fees of 0,80%).
He has to invest a minimum of € 10,000 in a unit of his unit-linked insurance contract.
He is provided with a link to the bond issue 76 page prospectus.

On February 7, 2009, he tried to check the market price of his investment.
On Boursorama.com, the biggest financial web portal in France, he cannot find the bond issue using the ISIN code (XS0402707367, provided by the online broker) or the issuer's name.
After going to Google, he discovers there is another code (A0T4DX) that works better to look for trading data.

The prospectus mentions that the issuer will ask for trading on the London Stock Exchange.
The fact sheet from the insurer mentions instead a listing in Luxembourg.
But the investor eventually finds quotes only coming from Frankfurt, Germany.

- Last quote on Boursorama is for February 6:

- Opening: 106,10
- High: 106,10
- Low: 106,10
- Volume: 0

- Only quote on BondMarketPrices.com (Xtracker, supposing this retail investor knows this site, which is very unlikely) is for February 6:

- Median: 107,41
- High: 107,69
- Low: 106,12
- Volume: data for the month of December 2008 only
- Average bid offer closing quotes: 106,94 / 107,85

It is not possible to get previous days' data.

- Only quote on the online broker's site:

January 30, 2009: 1059,76 €
(for January 30, Boursorama quote is 105,34, not available on Xtracker).

Conclusions:

- it is very difficult for a retail investor to find bond trading data.

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- These trading data are sketchy and seriously inconsistent from one source to another: the low price from one source is higher than the high price on the other ! Therefore the trading data integrity is highly questionable.
- Only one source for daily trading volume, but highly doubtful as it is 0 every trading day.
- No information on the yield anywhere
- Only one source provided a bid/offer spread data, but only for one day and only at closing.

Therefore, it is impossible for this retail investor to have any idea of the price he could sell at.

ANNEX 2

Six Vanguard offshore funds temporarily closed to new investors

Vanguard has announced the temporary closure of six offshore bond index funds to all new investors effective on 2 February 2009. The funds are:

U.S Investment Grade Credit Index Fund
Euro Investment Grade Bond Index Fund
U.K. Investment Grade Bond Index Fund
Eurozone Inflation-Linked Bond Index Fund
30-40 Year Duration Euro Index Fund
Global Bond Index Fund

Vanguard has taken this proactive step in order to protect shareholders in the funds. The persistence of severe illiquidity in the bond market serves to increase the transaction costs associated with purchasing securities when new cash is invested into the funds. Such costs have the potential to reduce a fund's returns and cause tracking error relative to a fund's benchmark.

The funds remain open to existing clients, although given the ongoing volatility in the credit markets we reserve the right to refuse additional purchases if we believe such investments may be detrimental to the other shareholders in the fund. We suggest that clients notify us one day in advance of any additional purchases to give the portfolio manager an opportunity to assess whether the investment can be accepted.

Also, as of February 16th, 2009, purchase fees for these bond funds will be significantly increased (at least doubled).

Source: Vanguard Investments Europe website, February 2009