

Transparency Proposals for European Sovereign Bond Markets

Peter G. Dunne*

The debate over the possible extension of transparency regulation in Europe to include sovereign bonds has opened up a number of other issues in need of serious consideration. One such issue is the appropriateness of the entire infrastructure supporting the trading of European sovereign bonds. In recent years, sovereign issuers have supported the development of an electronic inter-dealer market but have remained unconcerned about the opacity of dealer-to-customer trading. The degree of segmentation in this market is high relative to what exists in nearly all other financial markets. This paper explores why European sovereign bond markets have developed in such a segmented way and considers how this structure could be altered to improve transparency without adversely affecting liquidity, efficiency or the benefits enjoyed by primary dealers and issuers. It is suggested that the structure of the market could be improved greatly if the largest and most active investors were permitted access to the inter-dealer electronic trading platforms. This would solve a number of market imperfections and increase the proportion of market activity that is conducted in a transparent way. The paper argues that sovereign issuers in Europe have the means to provide incentives that would influence dealers to support reduced segmentation. Some practical examples of how this could be achieved are provided and the potential benefits are outlined.

1. Introduction

Due mainly to regulatory activity, financial market transparency has become the subject of much recent interest within the finance industry as well as in academic circles. The word ‘transparency’ is used in this context to mean how visible market activity and prices are. Regulation in this area is usually aimed at increasing transparency and regulatory intervention usually reflects a view that, when left unregulated, a sub-optimal level of transparency is chosen by Self Regulatory Organisations. The term ‘increased transparency’ can be used to imply that prices and traded quantities are made observable to a wider audience than before. It may also mean that more sensitive details about trades are revealed, or that information is revealed more quickly than before.

Pre-trade transparency requires that customers and/or their agents have access to publicly observable ‘firm’ quotes at which they can expect to trade. Post-trade transparency concerns the dissemination of information about recently obtained prices (and could include information about quantity traded). Such information can assist investors in comparing the prices they obtained in their recent trades with that achieved by other investors, and this kind of transparency can act as a motivation to agents acting on behalf of clients to provide what is known as ‘best execution’.² Perhaps of more fundamental importance,

however, is the fact that pre-trade, and particularly post-trade, transparency can have significant effects on information asymmetry within the market, and can therefore change behaviour of participants in ways that may, or may not, be beneficial to market quality.

The main objection to excessive transparency comes from agents who provide liquidity to investors on-demand. These agents regard a degree of opacity as necessary for the safe unwinding of large, unwanted positions. They argue that excessive transparency would raise the risks of providing liquidity on-demand and reduce the supply of liquidity services and therefore reduce the quality of the market.

This is the subject of an extensive academic literature that has recently been contributed to and surveyed by Biais et al. (2006) and Dunne et al. (2006).³ This literature is

Mr Dunne wishes to thank Euro-MTS Ltd for providing both inter-dealer trade and quote data and BondVision data. He also wishes to acknowledge important comments he received from an anonymous referee, which have substantially improved his paper.

¹ The views expressed here regarding the determinants of the existing structure of the euro-denominated sovereign bond market were formed as a result of numerous interviews with market participants. The questions used in these interviews and a list of the companies/associations of the interviewees are available from the author on request.

² It is worth noting that the term ‘best execution’ can be used by regulators to mean more than just a fair price. For example in the case of MiFID Article 21, best execution is about obtaining the best possible result, taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order.

³ See also Casey (2006), who is favourably disposed to increased transparency in fixed income markets (http://shop.ceps.be/downfree.php?item_id=1420).

* Peter G. Dunne is a lecturer in Finance at the School of Management and Economics, Queen’s University, Belfast, Northern Ireland. The views expressed in this paper were formed as a result of numerous interviews with market participants. The questions used in these interviews and a list of the companies/associations of the interviewees are available from the author on request (email: p.g.dunne@qub.ac.uk).

divided on whether the effects of such regulation are unambiguously positive. It should also be recognised that it is sometimes difficult to assess the effects of regulation alongside the effects of improvements in trading technology, which can also be credited with improving the dissemination of pre- and post-trade information as well as adding to market liquidity and raising efficiency.

There is a significant recent history of regulatory initiatives in financial markets in respect of transparency.⁴ And regulation of transparency is an area in which regulators have claimed some success in terms of improving market quality and liquidity. While this paper focuses on euro-denominated sovereign bond markets, it is worthwhile considering how transparency regulation has developed elsewhere and in other financial markets. The most pro-active regulator has been the Securities and Exchange Commission (SEC) in the US. The SEC has been particularly active in regulating transparency of the National Market System for equities and in the corporate bond market (see Box 1). Developments in these markets have prompted the SEC, and other regulators, to extend their horizons.

Box 1. Transparency initiatives undertaken by the SEC

Equity market transparency regulation in the United States has been heavily influenced by the amendments to the Exchange Act in 1975 where Congress directed the SEC to facilitate the development of a National Market System for the trading of equity securities. Congress set out goals for this system that included; efficient execution of transactions, fair competition, the availability of quote and trade information to market participants, best-execution of investors' orders and the opportunity for investor orders to be executed without dealer intervention. The SEC has been relatively consistent in pursuing these goals and these principles have been echoed by other regulators ever since.

A recent example of SEC activity is Rule 605, adopted in November 2000, which required market centres to make monthly public disclosure of execution quality of its members. According to Zhao & Chung (2006), this led to significant improvements in execution quality.

Transparency regulation in the US has also been tried in the case of corporate bond markets. Following pressure from the SEC, a transparency initiative called the Trade Reporting and Compliance Engine (TRACE) was introduced in an experimental way in the US corporate bond market in July 2002, and has been credited with attracting increased retail investor involvement and improving liquidity.

The SEC has been somewhat less pro-active in directly regulating the US Treasury market but even here an industry-led initiative, known as GovPX, was implemented in the early 1990s. In the UK gilt market, the issuer has been very cautious in its approach to such regulation. In the late 1990s, after a delicate consultation process with market participants, the UK Debt Management Office (DMO)

introduced a formal segmentation of trading arrangements. In the inter-dealer segment, gilt-edged market makers (GEMS) were allowed to operate with very limited transparency of their activities beyond the boundaries of the inter-dealer space. Trading activity in the dealer-to-customer segment also remained quite opaque.

In the euro-denominated sovereign bond markets, issuers have also been careful in their approach to transparency. Many of the smaller European issuers have imposed obligations on primary dealers that have resulted in some improvement in transparency in the inter-dealer market. There is still quite limited transparency of the dealer-to-customer market, however.

In Europe, the next phase of transparency will be imposed by the regulatory aspects of the Markets in Financial Instruments Directive (MiFID) from 1 November 2007. Initially, these will be put into effect by the national regulators for equity trading, which will be subjected to quite stringent pre- and post-trade transparency requirements.

It remains to be seen whether the effects of these requirements will be positive, but Article 65(1) of MiFID has now shifted the transparency debate to other markets where the benefits of transparency are regarded as more difficult to confirm. Article 65(1) called for a report from the European Commission in relation to the adequacy of the level of pre- and post-trade transparency in classes of financial assets other than equities. The corporate and sovereign bond markets are now the main focus of attention, and judging by the responses to the Commission's consultation calls, there seems to be little appetite among market participants for increased pre- and post-trade transparency in these cases.⁵

The target of MiFID-style transparency regulation is mainly 'off-exchange' and 'over-the-counter' (OTC) trading. It is easy to see why fixed-income asset markets come into the view of regulators as very suitable targets for such regulation. After all, off-exchange and OTC trading in bonds is much more prevalent than it is in the case of equities. Many of the publicly available responses to the Commission's consultation process on extending MiFID to fixed-income markets place considerable emphasis on the differences between equity and bond markets, and argue that these differences either negate the need for similar regulation or make such regulation unsuitable and perhaps even damaging to market quality. While this may be a valid argument, there has been a tendency to take the current bond market structure (and its difference from the equity market) as a given. There is a lack of analysis of the deeper issue as to why these markets differ and whether transparency itself can partly explain the structural differences.

The next section of this paper – Section 2 – examines the relevant differences between equity, corporate and sovereign bond markets in general and considers the forces

⁴ See Edwards (2006).

⁵ See the Commission's responses to the consultation calls (http://ec.europa.eu/internal_market/securities/isd/mifid_reports_en.htm).

that have brought about the current structure of the euro-denominated bond market in particular. This concludes with the view that the structure of bond markets in general is significantly different from that in equity markets and this is likely to affect how transparency regulation impacts on the quality of the market. It also highlights the potential for considerable conflict between the Commission and sovereign issuers regarding the appropriateness of transparency regulation because issuers have an interest in maintaining the existing structure and can make a 'second best' argument for the status-quo.

Section 3 of the paper makes tentative proposals that, it is argued, would reduce the segmentation of this market. If implemented, the proposal would result in dealers competing with each other for investor trades in a common transparent setting. This involves widening access to the electronic inter-dealer market. It would require changes to the incentive structure underlying primary dealer behaviour and also some slight modifications to both platform-design and management. These proposals arise as a direct result of the detailed examination of the current structure and its causes. They are not excessively detailed but provide a blueprint for realistic policies that are more likely to improve market transparency and efficiency than would a direct application of MiFID-style regulation.

2. The structure of European sovereign bond markets

An initial step in gaining an insight into the peculiarities of the European sovereign bond market is to recognize that, in general, fixed income markets are substantially different from equity and most other financial markets (this is addressed in the extant literature by Gravelle, 2004). An important difference (from the point of view of transparency regulation) between equity and fixed-income markets arises from the fact that intermediation in the bond markets is mostly carried out by dealers who act as principals and deal 'for-their-own-account'. Their clients are generally well-informed professionals. In contrast, in equity markets, intermediation is more likely to be facilitated by brokers acting on behalf of customers who are often not professionals. Thus, there is a greater prevalence of dealers providing liquidity 'on-request' in the bond market.

Although not exclusively the case, intermediation in the equity market is more likely to be concerned with finding liquidity or simply matching trades against available limit orders on an electronic order-book. Since bonds are usually traded in very large amounts, dealers frequently take temporary possession of large bond positions and this exposes them to significant inventory risk. In contrast, inventory risk is not as acute for intermediaries in the equity market.

Probably a more important difference between equity and fixed-income markets is the fact that the latter tend to be more segmented into inter-dealer (B2B) and dealer-to-client (B2C) parts than is commonly true of equity markets. It is also arguably the case that dealer-to-client relations are more exclusive in bond markets, with customers displaying

considerable loyalty to their chosen dealer. This makes dealer-to-client trading inherently less transparent.

While it not uncommon for financial asset markets to be segmented into dealer-to-customer (the so-called B2C market) and dealer-to-dealer (B2B) parts, the degree to which it applies in the euro-denominated sovereign bond market is rather strict. In the euro-denominated sovereign bond markets electronic order-books are in operation, but only in the inter-dealer segment of the market where liquidity is provided by dealers acting as principals on their own accounts.

As a contrast, in equity markets, e.g., Euronext Paris or SETS in London, investors can indirectly contribute to order-book liquidity by way of 'limit-orders' (or one-sided quotes) through their broker. An electronic order-book aggregates and distributes all prices (and quantities) at which agents are willing to trade and this provides a high degree of transparency. In most cases, these electronic venues allow agents to electronically execute trades remotely against the available prices quoted.

While fixed-income markets differ from equity markets it is also the case that sovereign bond markets are quite different from corporate bond markets. This is due to the fact that, in sovereign markets, issuers (governments or their agents) have largely dictated how the primary and secondary markets are structured. This is because, as Martinez-Resano (2005) has highlighted, sovereign issuers employ primary dealer systems and are monopsonistic buyers of liquidity services. As a result, they can exert a great deal of pressure on dealers to behave in a way that is beneficial to issuers.

The B2B-B2C division of the euro-denominated bond market arises in part from historical accident but it is very likely that it is perpetuated by the policy of issuers in employing primary dealer systems (PDS). Because bonds are usually designed with a finite-life to maturity, issuers rely heavily on primary dealers to regularly distribute new issues of bonds to the investor community. Clients are dependent on good supply from their dealers and dealers are driven by various forces to maintain a steady flow of secondary market business from their clients.

It is difficult to be certain about cause-and-effect in maintaining the B2B-B2C segmentation, but once it is in place the following propositions are likely to be supportable: i) issuers are better-off distributing new bond issues through dealers rather than to investors directly, ii) dealers are better-off building and maintaining a client base that is large enough to warrant the risk exposure they enter into by providing liquidity on the secondary inter-dealer bond market and iii) clients are better-off routing most of their order flow through one dealer because they can expect better execution when they assist their dealer in keeping trading positions hidden from competing dealers. While this system is probably self-perpetuating it is also inconsistent with full-blown transparency in either, or both, segments of the market.

There are a number of other peculiarities of the market structure that add nuance to this argument. For example, the primary distribution of bonds favours dealers that have

regular voice communication with a network of clients because it is easier to plan distributions when client demands are better understood. Voice communication in a repetitive trading situation also contributes to building trust and commitment. But voice communication is almost always bilateral and therefore, much of the trading in bonds ends up being opaque.

The inconsistency of the current bond market structure and transparency also reflects the dependence of the issuer on the services of primary dealers and vice-versa. The regularity and speed with which issuers need to distribute new issues dictates that there is heavy reliance on dealers. But dealers also become dependent on their own successful participation in primary auctions and in syndicated issues.⁶ Dealers taking a bigger proportion of new issues at primary auctions become the source of a reliable supply for a bigger client base (or a client base made up predominantly from the largest investors in the market).

Issuers can take advantage of the fact that most primary dealers must participate well in primary auctions in order to properly maintain their client base. Privileged access to primary supply is frequently only one part of a typical relationship between sovereign issuers and primary dealers. The other part involves the extraction of commitments from dealers to provide secondary market liquidity on the inter-dealer electronic platforms.

In the case of smaller European issuers, dealers often enter into obligations that require them to quote relatively small maximum bid-offer spreads for relatively large minimum quantities for as long as five hours a day. These commitments are entered into with no guarantee that sufficient customer transactions will be available to make the activity worthwhile. This in turn exerts great pressure on dealers to compete with each other for client business. Dealers are more likely to compete with each other to win clients rather than to win individual transactions (although the latter does occur on request-for-quote platforms).

Dealers obtain a positive externality when an issuer imposes obligations on a significant number of dealing banks. This is because such obligations make it easier to place unwanted inventories if necessary. In the absence of widespread obligations, no single dealer would be willing to provide such a degree of liquidity unilaterally because the associated risks would be excessively high.

The segmented structure of the market is also perpetuated because dealers are obliged to be involved in primary auctions and this concentrates distribution. This sometimes leads to dealers out-bidding investors at primary auctions. Since dealers have more incentive to compete for primary supply against their competitors in order to service their client base, investors are 'crowded-out' of the primary

market.⁷ This simply reinforces the perception among investors that the most secure access to primary supply is through dealers and it further encourages them to maintain close links with a single primary dealer. It also makes the dealer system worthwhile for the issuer. Issuers obtain the benefit of lower cost borrowing when dealers have incentives to bid more competitively with each other for supply.⁸ Many dealing banks claim that primary dealing itself is not profitable. This indicates the presence of other benefits arising from the maintenance of the client base.

This situation can be more acute where issuers engage in syndicated issuance. This issuance strategy is used by many of the smaller sovereign issuers in Europe and some of its consequences have been analysed by Dunne et al. (2006). The main point is that lead-managership of syndicated issues is sometimes awarded to primary dealers who have been the most active participants of primary auctions and the most dedicated providers of liquidity in the secondary bond market. Since lead-managership of syndications is a directly profitable activity for dealers (involving relatively lucrative fees) their over-bidding at primary auctions is further encouraged since they bid in lieu of an additional expected reward.

Syndicated issuance also enhances the position of dealers in the eyes of their clients and encourages them to reinforce their commitment to their dealer. It concentrates the supply of new issues among fewer dealers. It favours dealers with larger client bases and may lead to discriminatory distribution practices where smaller investors achieve less security of supply. Overall, syndicated issuance encourages opaque trading between dealers and their clients.

The primary dealer system can also be credited with stymieing the growth of an electronic dealer-to-customer secondary market. This is because segmentation introduces a lag between the customer expressions of willingness to trade and order-execution. This time-lag becomes important if electronic trading modalities increase the speed with which trades in the dealer-to-customer segment of the market are made known to participants in the B2B segment. This encourages behaviour that is potentially damaging to market quality in one or other of the market segments. A good example of this is the relatively limited development

⁷ There are exceptions. In the Netherlands, the Dutch State Treasury Agency sometimes gives preference to end-investor bids over primary dealer own-account bids in primary auctions. These auctions have become known as Dutch direct auctions (DDA).

⁸ It should be noted that collusive under-bidding has often been a concern in the US Treasury market. This is not as likely to be as acute a problem in the European context because there are a greater number of primary dealers in Europe and a large number of sovereign issuers with different subsets of the dealer community participating in each market. Thus collusion is more difficult. There are currently 22 primary dealers operating in the US Treasury market that are listed as reporting to the issuer on the NY Federal Reserve's website. In the eurozone there are approximately 55 primary dealers.

⁶ Syndication operates like a private placing of stock. A number of the large banks may be involved in the syndication but a single lead manager will usually be appointed by the issuer. An underwriting fee is earned by the lead manager of the syndicate. This covers the operating costs and the risk that the issue will not be fully distributed at a good price.

of multidealer-to-client request-for-quote (RFQ) electronic trading modalities in the dealer-to-customer bond market.⁹

Request for quote systems allow investors to request quotes from a number of dealers simultaneously. Dealers can respond to such requests very quickly and trades can be executed electronically. There are no significant B2C electronic order books, so pre-trade transparency of the B2B market must suffice as the best guide to prices that investors can expect to obtain in potential B2C trades. Investors can of course request quotes simply to gain pre-trade information but investors can't be sure that they are receiving the same information as other investors. It should also be noted that dealers do not generally know what prices are being quoted by other dealers (although on most RFQ platforms the under-bidder is informed that they quoted closest to the accepted price).

RFQ systems are a significant improvement over voice communication in terms of ease and speed of trading. These platforms also bring dealers into direct competition with each other for client trades and this would be expected to deliver price improvement for investors. It could also be seen as a direct way of breaking down the clientele system. On the negative side however, RFQ platforms can pose problems for dealers who win automated RFQ auctions. Thus, despite the fact that these platforms have limited transparency, even this limited amount is potentially excessive when there is market segmentation.

To see this, consider the following example. Suppose an investor approaches five dealers wanting to sell a large quantity of bonds. A request for bids is generated and regardless of their intentions to actually provide good prices, the dealers each have an incentive to prepare for the consequence of the B2C trade by engaging in offsetting activity in the B2B market. They are likely to do at least one of the following: i) place a sell order for immediate execution against the best bid limit-order on the electronic order-book, ii) place a limit-order to sell at a price that shades the best existing ask limit-order on the book or iii) remove or reduce the quantity of any limit-orders currently outstanding on the bid side of the order-book.

All of these options are obvious responses to the customer trade even if the dealer concerned does not win the customer business. If the dealer wins the B2C auction, by selling in advance on the B2B market he is effectively hedging the position. Even if a dealer loses the B2C auction, by selling in advance in the B2B market he will have avoided any temporary price movement that may arise as a result of the trade. If a dealer reduces his exposure on the bid side of the book, he will be avoiding being 'picked-off' at a price that may be worse than he could have achieved.

⁹ The current state of purely electronic trading facilities in the two segments of the euro-denominated sovereign bond market can be described as follows. B2B electronic trading platforms include BrokerTec, Euronext and MTS (the MTS platforms combine country-specific and euro-benchmark markets). The B2C segment mainly consists of request-for-quote (RFQ) platforms, including BondVision (a subsidiary of euro-MTS), TradeWeb and Bloomberg-Bond-Trader (BBT).

It is easy to see that the RFQ system has one critical disadvantage: namely, the delay between 'requests' and the actual implementation of a trade. When more than one dealer is involved, this delay allows for activity to take place in the B2B market in such a way that being the winner of a B2C order is not always beneficial. This 'winner's curse' problem has been examined by Dunne et al. (2006) and it highlights just one of the many problems that arise from the forced segmentation of the market.

So far, RFQ systems have had limited penetration in the market for B2C liquidity provision but if they succeed in winning a more significant proportion this can be expected to undermine the clientele system and the presence of a winner's curse is likely to diminish the importance of B2B platforms. Obligations placed by issuers on dealers to provide liquidity in the inter-dealer market is of course a countervailing force to this and perhaps accounts for the slow growth of RFQ platforms.

To support this analysis, it is worth noting that monthly turnover in German and French benchmarks on the BondVision system is only about two-thirds of a percent of the amount issued. For Italy it is about 2.5% of issued benchmarks.¹⁰ This is not high when one considers that B2B turnover on MTS is over 16% for Italy.

It is also helpful to examine the size of trades conducted on RFQ systems with those on B2B platforms. Figure 1 at the end of this paper shows this comparison for the MTS B2B platform and the BondVision RFQ system. Although there are a small number of very large trades on the BondVision system, about 75% of all BondVision trades are smaller than the smallest trade size on the B2B platform. This reflects the excessive transparency of the RFQ system and the fact that this level of transparency does not easily accommodate large trades.

Since the RFQ system does not provide pre-trade transparency, except on request, the information provided by the B2B segment must substitute. Thus, while the success of an RFQ trading system is at odds with the smooth running of the B2B electronic platform, the RFQ system itself cannot function very well without B2B transparency. A 'catch-22' for transparency regulators is therefore, that imposing increased transparency on B2C activity increases the risks and reduces the incentives for dealers to provide continuous liquidity in the inter-dealer market.

Indeed, any form of transparent trading modality in the B2C segment (such as the introduction of a parallel electronic order-book) could represent a large threat to the efficient working of the B2B electronic trading system and this might in turn alter the entire structure and approach to primary issuance. However, the contrary argument also holds. The fact that issuers have favoured the continued health and transparency of the MTS B2B platform has

¹⁰ This is an estimate based on information provided by euro-MTS regarding BondVision volume combined with information about amounts outstanding of benchmark bonds in Tables A1.5, A1.6 and A1.9 in Dunne et al. (2006).

reduced the incentives for dealers to trade with customers in a transparent way.

It is clear from the above discussion that: i) euro-denominated sovereign bond markets suffer from an excessive degree of segmentation due mainly to the policies of sovereign issuers, ii) issuers have actively supported the development of a liquid inter-dealer market in euro-denominated sovereign bonds but do not impose obligations on dealers to provide liquidity to end-investors in a transparent way,¹¹ iii) the B2B euro-denominated sovereign bond market is very transparent, iv) the B2C segment is mostly characterized by off-exchange OTC or RFQ modes of trading and these are not as transparent as regulators would like, v) B2B transparency is crucial to the efficiency of the non-transparent B2C market, vi) transparency cannot be imposed in the B2C segment without affecting the efficiency and liquidity of the B2B segment and vii) imposing further transparency requirements on the B2B segment is very likely to continually limit the development and growth of transparent B2C trading modalities.

3. Going forward

Since excessive segmentation affects the quality of at least one part of this market, it is worth considering whether the market can be made to be less segmented. Given the already well developed nature of the B2B segment and the commitment of issuers to the primary dealer system, it seems reasonable to extend the reach of this segment so that it can encompass some B2C activity. This is the only way to fully circumvent problems such as the ‘winners curse’ associated with excessive post-trade transparency that arises when there is a two-stage approach to trading (B2C followed by B2B).

There is therefore a case to be made for attempting to widen access to the B2B segment of the euro-denominated sovereign bond market. A complete opening of the B2B segment is not necessary. Small trades can still be accommodated using RFQ platforms without serious side-effects in terms of investor protection or inventory risk for intermediaries. Very large trades in less liquid, ‘off-the-run’ bonds could also be better accommodated in an OTC setting where there is delayed post-trade transparency. But there is a significant proportion of investor trading, at least in the case of benchmark bonds, that could be accommodated on the existing B2B platforms.

Widening access to the B2B platforms is not completely at odds with current developments. There is already a significant degree of investor involvement in the B2B segment of the US Treasury market. This is by way of algorithmic trading. Dealers in this market provide some of their customers with trading software that routes investor trades straight through to the inter-dealer eSpeed and BrokerTec markets. Since these are trades that may have

previously been done OTC, this development can be credited with improving the overall transparency of the market. Crucially, for the dealers and customers involved, there are mutual benefits associated with this development.

Investors obviously value the fact that electronically assisted trading can manage trades while monitoring the state of the market in such a way that better execution outcomes are more often achieved. Investors also value the additional degree of autonomy they receive. Also, the lag between investor expressions of trading interest and the actual execution of trades is generally shortened.

Dealers may also benefit because this arrangement helps in maintaining client loyalty. It generates other business as well as fee-income and assists in keeping position information ring-fenced. It also augments turnover statistics of the facilitating dealers and this can be beneficial for their relationship with the issuer. Furthermore, it transfers some dealer inventory risk directly to investors. More generally, benefits accrue to all market participants if this leads to increased liquidity.

One potential drawback however, is that dealers can ‘snoop’ on the algorithmic trading of their own clients and this might interfere with how they choose to transact other business that they are facilitating at the same time.

Recently, in the case of euro-denominated sovereign bond markets, there have been calls from hedge funds to gain access to the MTS inter-dealer electronic platform.¹² From a market transparency point of view, allowing large, active investors direct access to the electronic inter-dealer market has many of the advantages associated with client-based algorithmic trading. It adds to the transparency of B2C trading and at the same time, generally, improves the efficiency and liquidity of the electronic order-book. Direct access for investors would also be more favourably looked upon by regulators than would the provision of algorithmic trading. This is because dealers would not be privy to the transactions being ‘worked’ by investors and they therefore would not be in a position to ‘front-run’ their own clients.

Unfortunately, in the European context, it is not clear that mutual benefits would accrue to the parties most affected by this development. This is mainly because liquidity is supplied in the European inter-dealer market as a result of the onerous obligations that are placed on primary dealers. If investors are permitted to by-pass dealers completely then dealers will suffer reduced B2C turnover and this reduces the core activity upon which their B2B activity rests. Dealers are unlikely to be as keen to adhere to obligations if they cannot generate enough customer trades to warrant the risks involved in continuous liquidity provision.

Dealers are indeed entitled to argue that access to the inter-dealer market should be combined with obligations in just the same way that obligations apply to primary dealers. Hedge funds, or other end-investors, should not have all the benefits of access to this market without also being exposed to some of the risks associated with continuous liquidity

¹¹ The Belgian issuer in fact encourages the provision of liquidity to customers in an off-exchange way. See the code of conduct for Belgian primary dealers (<http://www.debtagency.be/Pdf/Code%20of%20duties%20PD.pdf>).

¹² See the *Financial Times*, 10 October 2006.

provision. Investor involvement in the inter-dealer market would also increase competition in this segment, and this may not be palatable for dealers.

Given these considerations and the absence of fee-income and turnover attribution, there is little to recommend this development to dealers. Widening access might therefore appear to be a lost cause. However, in the case of the sovereign bond markets there are some obvious ways to address the concerns of primary dealers. Unlike almost all other markets, issuers have a lot of power over intermediaries and trading platforms in this case, and the effective use of this power has been well documented in Dunne et al. (2006). If issuers can be persuaded that transparency is worth improving, they could use their influence to alter trading platform management and provide incentives to dealers to acquiesce to investors wishes for more direct access to the B2B segment.

One way to achieve this is to reduce, or eliminate, the **quoting** obligations of dealers on the inter-dealer trading platforms. This would answer the “no access without obligations” argument. The inter-dealer market is already very well established and it is probably not as heavily dependent on primary dealer obligations for its survival as it once was.

Dealers quoting obligations should be replaced by alternative obligations relating to the percentage of investor trades that dealers facilitate in the B2B market. Facilitation should be defined in two distinct ways. The first way should be in terms of an ‘agency role’ played by dealers. Specifically, dealers who sponsor and route investor quotes to the B2B platform should obtain some recognition for this from issuers. The second way should be defined in terms of a ‘counterparty role’ played by dealers. In other words, dealers should be given credit by the issuer for the extent to which they act as counterparty to investor trades on the B2B market (i.e., by the ‘taking’ of investor offers or the ‘hitting’ of investor bids).

As a matter of practical importance, this proposal requires that ‘investor quotes’ are identified as such on the B2B platforms. This could be achieved by colour-coding them. There is no need to reveal the identity of investors making the limit-prices or the dealers sponsoring them. And this proposal does not require any change to the time priority rules applying to the queuing of orders.

Since investors would only be able to access the inter-dealer market by being sponsored by a particular dealer, this would maintain the clientele system that is so valuable to investors, dealers and issuers during primary distributions. If issuers place obligations on primary dealers to provide this type of facilitation of investor quotes, they can encourage increased liquidity provision, contribute to a healthy clientele system and achieve significant improvements in market transparency.

With the proper trading platform design, where investor limit-orders are visible as such, dealers could compete with each other to trade more often with investors than with each other. This trading could be given a high weight in dealer turnover statistics. The reward for high turnover with

investors can then be given in the form of privileged access to primary auctions and conversion facilities as well as increased likelihood of participation in syndicated issuance. By changing the weight applied to this turnover, the rewards could be modified progressively towards a level that encourages what is viewed by issuers (or the regulator) as an optimal level of investor activity in the transparent segment. These changes are also likely to reduce trading costs and the time it takes to execute orders.

Changes of this type are inherently complex and their side-effects are difficult to predict. A cautious approach would therefore need to be taken. The main point however, is that issuers (in consultation with dealers and the electronic trading platforms) have the power to provide incentives to intermediaries that could bring about significant improvements in both transparency and liquidity. Ultimately, the modifications being proposed here involve dealers competing with each other, not just to maintain their client base, but also for investor transactions in a transparent setting.

There are probably many ways that the general principle underlying this proposal could be put into effect and it would be possible to move in this direction over time in a protracted way so that there is time for adjustment. This proposal is likely to require minor changes in trading platform design. Issuers, dealers and trading platform providers would be well-placed to agree the specific details of such changes and there is good reason to suspect that the major trading platforms would be capable of monitoring the performance of dealers and coping with the increased level of participation that these proposals would require.

4. Conclusion

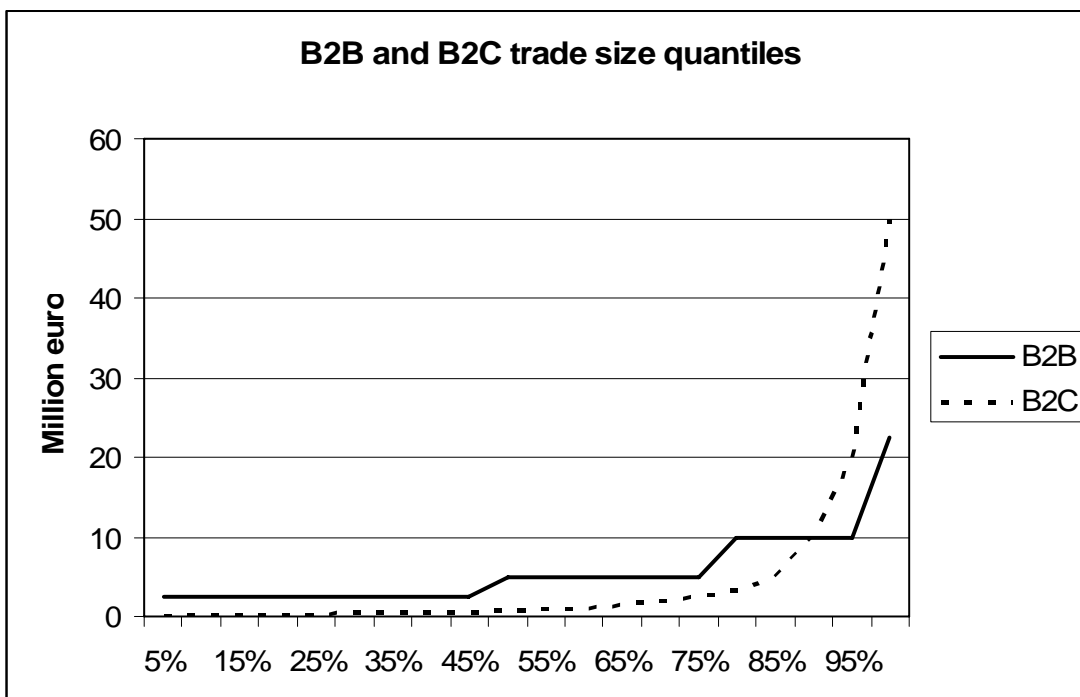
The segmented nature of the euro-denominated sovereign bond markets provides an immediate obstacle to the application of MiFID-style transparency initiatives. Strategies for the distribution of bonds through primary dealers have encouraged clientele-building and opaque dealer-to-customer trading modalities.

A relatively straightforward proposal is made here that has the potential to reduce market segmentation. It is argued that this would improve the kind of transparency that matters for investor protection in the spirit of MiFID. However, it is admitted that this would rely on providing sufficient motivation to primary dealers to provide liquidity to investors by widening access to the inter-dealer segment of the market. It is argued that European sovereign issuers have the power and influence to achieve this outcome. One way to view this proposal is as a call for a reorientation of obligations and incentives to bring about a reduced segmentation of the market and a spreading of the burden of liquidity provision across a wider group of market participants. It is argued that this would improve all aspects of the sovereign bond market that matter to investors, dealers, issuers and regulators without inflicting significant damage to any of them.

References

- Biais, B., F. Declerck, J. Dow, R. Portes and E-L von Thadden (2006), “European Corporate Bond Markets; Transparency, Liquidity, Efficiency,” paper commissioned from Centre for Economic Policy Research (CEPR) in London by ABI, European High Yield Association, ICMA, IMA, LIBA and City of London Corporation, published by the City of London Corporation.
- Casey, J-P (2006), “Bond Market Transparency: To Regulate or Not to Regulate”, ECMI Policy Brief No. 4, European Capital Markets Institute (ECMI), Brussels, 12 December (http://shop.ceps.be/downfree.php?item_id=1420).
- Dunne, P.G., M.J. Moore and R. Portes (2006), “Sovereign Bond Market Transparency, Liquidity, Efficiency”, paper commissioned from Centre for Economic Policy Research (CEPR) in London by ABI, EPDA, ICMA, IMA, LIBA and City of London Corporation, published by the City of London Corporation.
- Edwards, A.K. (2006), “Corporate bond market microstructure and transparency – The US experience”, BIS Papers No. 26, Bank for International Settlements, Basel, February (<http://www.bis.org/publ/bppdf/bispap26g.pdf>).
- Edwards, A.K., L.E. Harris and M.S. Piwowar (2004), “Corporate Bond Market Transparency and Transaction Costs”, Office of Economic Analysis, US Securities and Exchange Commission (<http://iltgserv.ucd.ie/seminars/ehp.PDF>).
- Gravelle, T. (2000), “The Market Microstructure of Dealership Equity and Government Securities Markets: How They Differ”, mimeo; Financial Markets Department, Bank of Canada.
- Martínez-Resano, J.R. (2005), *Size and Heterogeneity Matter: A Microstructure-Based Analysis of Regulation of Secondary Markets for Government Bonds*, Occasional Paper No. 0501, Banco de España, Madrid (<http://www.bde.es/informes/be/ocasional/do0501e.pdf>).
- Zhao, Xin and Kee H. Chung (2006), “Information Disclosure and Market Quality: The Effect of SEC Rule 11Ac1-5 on Trading Costs” (<http://ssrn.com/abstract=878351>).

Figure 1. Quantile by trade size in dealer-to-customer (BondVision) and dealer-to-dealer (MTS) segments of the euro-denominated bond market



About ECMI

The European Capital Markets Institute (ECMI) was established as an independent non-profit organisation in October 1993, in a collaborative effort by the European Federation of Financial Analysts Societies (EFFAS), the Federation of European Securities Exchanges (FESE) and the International Securities Market Association (ISMA), now the International Capital Market Association (ICMA). ECMI is managed and staffed by the Centre for European Policy Studies (CEPS) in Brussels. Its membership is composed of exchanges, banks, trade associations and academics.

European capital markets have experienced rapid growth in recent years, corresponding to the gradual shift away from relationship banking as a source of funding and at the same time, have had to absorb and implement the massive output of EU-level regulation required to create a single market for financial services. These developments, combined with the immense challenges presented to European financial institutions by the globalisation of financial markets, highlight the importance of an independent entity to undertake and disseminate research on European capital markets.

The principal objective of ECMI is therefore to provide a forum in which market participants, policy-makers and academics alike can exchange ideas and opinions concerning the efficiency, stability, liquidity, integrity, fairness and competitiveness of European capital markets and discuss the latest market trends. These exchanges are fuelled by the publications ECMI regularly produces for its members: quarterly newsletters, annual reports, a statistical package, regular commentary and research papers, as well as occasional workshops and conferences. ECMI also advises European regulators on policy-related matters, acts as a focal point for interaction between academic research, market sentiment and the policy-making process, and promotes a multidisciplinary and multidimensional approach to the subject.



European Capital Markets Institute

c/o Centre for European Policy Studies (<http://www.ceps.eu>)

Place du Congrès 1 • 1000 Brussels • Tel: 32(0) 229.39.11 • Fax: 32(0) 219.41.51

Website: <http://www.eurocapitalmarkets.org> • E-mail: info@eurocapitalmarkets.org