

Issue no. 3: October 2006

| | |
|---|----|
| The challenge of regulation: Hans-Joerg Rudloff | 1 |
| Bond market transparency | 2 |
| ICMA's response to the Commission's Call for Evidence | 3 |
| MiFID: implementation | 4 |
| Best execution | 5 |
| Clearing and settlement | 6 |
| Other regulatory policy news | 7 |
| Other ICMA news | 10 |
| Forthcoming ICMA events | 10 |

The challenge of regulation

By Hans-Joerg Rudloff, Chairman, ICMA

We are all aware that one of the great challenges to our market and our members is that of increased interest of regulators around the world in capital market activities. Well intentioned interest of course, in the cause of investor protection, but we owe it to the market in Europe to ensure that decisions to impose regulation to protect investors do not have unforeseen negative consequences for those same investors, whether by adversely affecting the liquidity or efficiency of the markets or by stifling growth, innovation and choice. Our overriding concern at all times is to support market-led solutions to market problems, resorting only to statutory legislation where there is a demonstrable market failure which the market itself is unwilling or unable to correct. This has been our position on the initiative to consider imposing pre- and post-trade transparency on the bond markets (see below).

The international diversity of ICMA and its correspondingly strong regional structure has always been one of its greatest strengths. ICMA is the only capital market trade association which can claim to represent a truly pan-European membership, even in these



days of continued mergers and acquisitions in the banking sector. We should remember also that ICMA represents the dealers who are the major suppliers of liquidity in this market as well as the wealth managers who require that liquidity in their fund management businesses.

We are fully committed going forward to representing the differing interests and perspectives of this community, from the largest global financial conglomerates in the City of

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Issue no. 3: October 2006

London to individual independent banks supporting retail clients in Switzerland, Italy, Germany and elsewhere. Indeed, we have as an immediate priority the extension of ICMA's international membership to an even broader capital market constituency encompassing major borrowers, as well as representatives of the buy and sell side. We will as necessary set up special interest groups under ICMA's auspices to accommodate these new members, again with the goal of unifying the voice of the whole market to the benefit of borrowers, intermediaries and investors.

We see the active participation of the ICMA regions as essential to the future growth and success of the Association. We have asked them, through the regional committees, to engage wholeheartedly with ICMA in the key areas of regulation and education by discussing with us their priorities and issues. We will be actively working with our regional committees to extend our membership in all countries and all capital market constituencies with a particular emphasis on the markets of Eastern Europe, including Russia and the Ukraine.

Engagement and support from our members is vital to our efforts to represent the interests of the capital market. We can only achieve this through improved communication and dialogue with the membership.

Hans-Joerg Rudloff

Bond market transparency

The European bond markets are a European success story. They are the most integrated of Europe's securities markets, characterised by an efficient and highly competitive over-the-counter (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.

In Europe the debate on whether to impose, by regulation, some form of mandatory quote obligation on bond and derivatives dealers in the OTC market has entered a crucial stage. If a mandatory quote obligation were to be imposed, that would be the most dramatic regulatory change in the 40 year life of the international debt market, with unpredictable and possibly damaging consequences.

This decision has already been taken as regards certain OTC dealing in equities. Under the pre-trade transparency provisions of the Markets in Financial Instruments Directive (MiFID), from November 2007 certain qualifying dealers in shares deemed liquid by European regulators will be obliged to maintain firm public quotes in those shares. Limitations will be imposed on a dealer's ability to vary prices and to negotiate with clients. In addition, post-trade transparency provisions will require all OTC transactions in shares to be published in real time with limited delays for blocks.

As required under MiFID, the European Commission has begun to consider whether to recommend a similar regulatory approach to both pre- and post-trade transparency for bonds and derivatives. As a first step, the Commission issued a Call for Evidence with a deadline for responses by September 15, 2006. [The responses](#) received by the Commission have now been published. The Committee of European Securities Regulators

Issue no. 3: October 2006

(CESR) will provide advice to the Commission by March 31, 2007. The Commission will issue a draft report by June 30, 2007, followed by a public hearing in July. Consultation will close in September 2007, and the Commission's final report will be published on October 31, 2007.

The UK FSA has carried out significant research into whether a market failure exists in the corporate bond market in the UK. Its findings are that, in essence, no market failure exists which would justify regulatory intervention, though there would be some scope for industry-led improvements in the availability of data for retail and smaller institutions. In order to ensure that the political debate is properly informed, ICMA has also funded (with others) independent academic research into Europe's bond markets which has reached broadly the same conclusions as the FSA. ICMA distributed this research widely among legislators and regulators across Europe, sponsored a conference in Brussels in June and co-hosted a seminar in Paris in September. More seminars are planned in Rome and at the ECB in Frankfurt before the end of the year. Further academic research on high yield debt is also underway.

Unlike equities, bonds are generally traded OTC and liquidity is provided by dealers. There is a high degree of pre-trade transparency and ICMA does not see the need to extend the MiFID provisions for transparency in equity markets to bonds. Our discussions with members will help us to decide whether the levels of post-trade transparency applied under ICMA's own rules as a self-regulatory body and through its TRAX reporting system should be further enhanced, and the data made more widely available.

This strategy was endorsed by the ICMA Board at its meeting on September 8. Fur-

ther consultation with the membership and committees will now take place to ensure that there is a broad consensus.

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ICMA's response to the Commission's Call for Evidence

[ICMA's response](#) to the Commission's Call for Evidence on *Pre- and post-trade transparency provisions of MiFID in relation to transactions in classes of financial instruments other than shares*, was submitted on September 15. The response describes ICMA's role as the SRO for the international debt market, the formal recognition of that role in the legislation of the UK and Switzerland and the contribution that ICMA, with the support of its members, currently makes to pre- and post-trade transparency. It notes the lack of evidence of a market failure, but also recognises that differences of view exist among some regulators and investors. It states that, in consequence, ICMA has begun to discuss with its members on the buy and sell side 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.

The response says: "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

Issue no. 3: October 2006

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.”

MiFID implementation

Now that the MiFID Level 2 negotiations are complete, the focus of the authorities – as well as the market – has shifted to implementation of MiFID by November 1, 2007. It is not clear that this will be practicable in all Member States. However, the UK authorities are committed to transposing and implementing MiFID on time. MiFID Connect (see below) has therefore raised with the UK authorities the potential problems (eg passporting across borders) that might arise in the event of staggered implementation.

A number of national regulators – eg the AMF in France and the AFM in the Netherlands – have published general papers on implementing MiFID, and the AMF has issued a specific paper on best execution. In the UK, the FSA has also begun publishing a series of Discussion Papers (DPs) and Consultation Papers (CPs) on aspects of MiFID implementation. The DP (issued in May) on best execution is the most contentious (see below). A CP (issued in May) on systems and controls – proposing a “common platform” in areas of overlap between the Capital Requirements Directive and MiFID – has broadly been welcomed by the industry. A separate CP was issued at the end of July on firms and markets, including transaction reporting. Conduct of business issues are due to be covered in a further CP in October. The FSA also published at the end of August a pre-consultation paper on client classification. We are collaborating with other trade

associations in responding to the FSA’s CPs. We have also participated in a [joint response](#) to CESR’s consultation on its Level 3 work programme.

ICMA has continued to be heavily involved in the work of MiFID Connect (www.mifidconnect.com), which brings together 11 financial services industry trade associations in the UK. One of the aims of MiFID Connect is to develop a set of focused industry guidelines to assist firms in the UK in those specific areas where the implementation of MiFID carries a high degree of legal uncertainty and regulatory risk. These industry bodies have been working with Clifford Chance in the preparation of guidance to MiFID. So far drafting has begun on guidance on MiFID requirements relating to best execution, suitability and appropriateness and conflicts of interest.

The drafting process commences with the identification of an area of MiFID that requires guidance (eg best execution). Once an area is identified, members of MiFID Connect practitioner committees send a list of issues (in the form of questions) to Clifford Chance relating to any uncertainty about MiFID requirements and how such uncertainty might affect their business. A document is then prepared by Clifford Chance which lists all the questions received. Each question is assigned by the committees a code which signifies whether it should be answered by the FSA, by industry guidance or whether it is a European issue that cannot be dealt with by the FSA or industry guidance but must be dealt with in a pan-European context. If the question is best left unanswered to ensure flexibility, a separate code is assigned for that purpose as well.

Once the questions are settled, Clifford Chance prepares draft guidance which attempts to deal with all the questions raised

Issue no. 3: October 2006

by MiFID Connect members (unless it has been decided in advance that a question should not be answered by industry guidance). The guidance goes through a number of redrafts depending upon the nature and volume of comments received from MiFID Connect firms. However, industry guidance is unlikely to be finalised until close to the FSA's transposition date.

Our work on implementing MiFID in the UK provides useful experience which should be relevant to ICMA members implementing MiFID in other countries, while recognising that each country has its own specific issues to address. ICMA held a specialised seminar in Frankfurt in June. With the help of ICMA's Regional Committee for Switzerland and Liechtenstein, three similar events are due to be held in November in Switzerland (Zurich, Geneva and Lugano) in cooperation with Swiss institutions (SWX, Ticino Banking Association, Genève Place Financière, Credit Suisse and the Swiss Association of Asset Managers). An event in Luxembourg is planned with the help of ICMA's Regional Committee for Luxembourg in early December involving the regulator (CSSF) and the local banking association. We are also hoping to hold similar events in the Netherlands and in Vienna. And we made a presentation at a MiFID conference organised by the Czech Ministry of Finance in Prague on September 14, followed by separate meetings with the Czech Ministry of Finance, Czech National Bank and both banking and securities industry associations. Further details of planned events can be found on [the ICMA website](#).

In conjunction with this programme of meetings on MiFID, ICMA is also taking the opportunity to present TRAX2 to firms and regulators as a tool for trade and transaction reporting under MiFID. The FSA has indicated that it intends to introduce an approval process for transaction reporting systems (ARMs – approved reporting sys-

tems), and it is likely that other CESR members will adopt a similar approach. So we are working with current and potential TRAX users to explain to CESR members that TRAX is well suited to be a pan-European reporting system.

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Best execution

The FSA DP in May on best execution under MiFID put forward a proposal on benchmarking best price. The proposal was researched by IBM. To guide our response, we immediately set up, jointly with the BMA and ISDA and in collaboration with LIBA, a working group that included the 20 largest global firms in dealer markets. There was a consensus in the working group both that the industry should make a forceful response to the DP, and on what the terms of the response should be. The working group also noted that the scope of the benchmarking proposal was unclear, as the FSA did not provide in the DP its interpretation of what constitutes "executing a client order".

In our response, we argued, first of all, that benchmarking was not necessary. There was no evidence of a market failure to justify the benchmarking proposal. And there had been no industry input into the IBM paper; as a result, most of its assumptions were flawed. We also argued that the benchmarking proposal was not consistent with the FSA's commitment to principles-based regulation and "intelligent copy-out". Nor was it consistent with MiFID Article 21 on best execution; nor with practice and regulation in global markets.

Second, we gave the market's assessment of whether benchmarking would work. We

Issue no. 3: October 2006

concluded that there were no robust benchmarks for most fixed income products, and that benchmarking was incompatible with OTC derivatives and structured products. In the limited areas where benchmarking would in theory be feasible, we argued that it was not necessary, as prices are already visible to most dealers and professional investors. Benchmarking would also be expensive to implement in practice.

Third, we considered the implications of benchmarking. There was a risk that liquidity would be withdrawn across the market as a whole. Requiring firms to disclose their internal models would pose risks to financial stability; innovation would stop; and dealers would be exposed to gaming by clients. The competitiveness of UK financial markets would be damaged. A change in market structure and firms' business models would be required. Costs for investors would be increased and information available to them reduced. We concluded that the costs and risks of the benchmarking proposal far outweighed any benefits.

Finally, we argued that there was a readily available alternative: a principles-based approach based on "intelligent copy-out" of MiFID, supplemented by MiFID Connect industry guidance, where market participants think this useful or necessary.

[Our response](#) was submitted to the FSA on July 14. Market firms used an FSA workshop on July 21 to reiterate the same messages. The buy side's view of benchmarking at the workshop was broadly similar to the view of the sell side. We are hopeful that the FSA will take proper account of the industry's view in the CP they are due to publish at the end of October.

Clearing and settlement

In July, the Commission announced a code of conduct for securities post-trade infrastructure providers. The code will supplement the provisions in Articles 34, 35, and 46 of MiFID on the choice of, and access to, securities settlement and clearing systems.

When the code is finalised, it will oblige signatories (clearing and settlement providers) to deliver the following results:

- by end-2006, a series of measures to improve price transparency;
- by mid-2007, a roadmap for ensuring effective rights of access with the aim of achieving interoperability between exchanges, CSDs and clearing houses as soon as possible;
- by end-2007, separate accounting of the main settlement activities and price unbundling (the accounting separation and unbundling of CCP services is being further explored).

The code will initially apply only to equities. It is due to be signed around the end of October. Compliance will be monitored on a provider-by-provider basis by external auditors. The auditors will report to a central co-ordination committee, including the Commission, the ECB and CESR.

ICMA welcomes the publication of the code (instead of a Directive). The code's success will largely depend on the efficiency of the monitoring process and of the "naming-and-shaming" sanction involved. ICMA member firms hope that infrastructure providers will make use of this opportunity for the market to resolve outstanding issues. In this context, we have expressed concerns – along with other trade associations – about the importance of involving users directly in the monitoring process.

Issue no. 3: October 2006

Also in July, the ECB opened discussions on extending the use of the TARGET2 payment system to the settlement of securities transactions in central bank money across the euro area (T2S). The project was specified in more detail in a paper, [Initial Assumptions and Questions](#), to which ICMA's European Repo Committee (ERC) has responded in [a submission](#). The ERC welcomes, from a practitioner's viewpoint, the ECB's initiative to study the creation of T2S. The ERC argues that "for efficiency reasons the project should cover all assets in euro. Ultimately it is the end user who will decide in which way settlement should be made. Central bank money is currently unavailable for certain products like tri-party. It would require the Eurosystem to allow both ICSDs to have direct access to the settlement system."

As in the case of the code of conduct, ICMA believes that the involvement of users in the governance of the T2S project is likely to be critical to its success. Further information on the T2S project can be found on the [ECB website](#), including a [speech](#) by Jean-Michel Godeffroy, Director General at the ECB.

Separately, in September, the Final Monitoring Report of the G30 on global clearing and settlement was published. The Report (whose executive summary is available [here](#)) identifies the progress made globally on the recommendation published by the G30 in early 2003.

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Other regulatory policy news

European Repo Council

ICMA's European Repo Committee (ERC) meets regularly to discuss developments in this rapidly growing market. Currently, GMRA legal opinions are published every year for 53 jurisdictions. The numbers have been growing steadily. ICMA is currently

considering the harmonisation of the legal opinions updating process for the GMRA and the stocklending agreements. At its most recent meeting, the ERC agreed to assess whether GMRA legal opinions could be obtained for Qatar and Oman in the Gulf. The ERC also recommended including Slovenian government bonds in euro collateral baskets when Slovenia joins the euro area on January 1, 2007. (See [repo market events calendar](#).)

Committee of European Securities Regulators

The Committee of European Securities Regulators (CESR) has made some important changes to its Charter so as to become more operational and to increase cohesion among its members. The changes include: the possibility of qualified majority voting on CESR advice to the Commission; the establishment of a mediation mechanism between members; and the formalisation of the review panel for which a specific protocol is being developed. In addition, CESR-Fin (financial reporting) and CESR-Pol (enforcement of market abuse) have been restructured to make these groups more operational. CESR-Tech, the new group charged with dealing with pan-EU IT projects stemming from EU legislation has been tasked with developing concepts for the sharing of data and transaction reports among CESR members. (See [CESR overview page](#).)

Prospectus Directive: complex financial history

Following several rounds of consultation, the Commission has published the [formal draft](#) of the amendment to the Prospectus Regulation on issuers with "complex financial histories". The draft confirms that competent authorities will be able to take a flexible approach when requesting supplementary historical financial information from issuers who have carried out, or are about

Issue no. 3: October 2006

to carry out, significant transactions. It addresses the key concerns we have raised earlier. Our [final response](#) to the Commission therefore fully endorses the adoption of the amendment.

Prospectus Directive: prospectus regime in Ireland

We are continuing with the series of practical seminars looking at the way the Prospectus Directive has been implemented and applied across the EU. The next seminar, to be held on 25 October, will address legal and practical aspects of offering and admission to trading of debt securities in Ireland. The presentations from the previous seminars can be found on the [ICMA website](#).

Transparency Directive: implementing measures

The Commission has published the [formal draft](#) of a Directive implementing the Transparency Directive – relating to the content of certain financial statements, shareholding notifications and dissemination of information to the market. In the [ICMA response](#) to the Commission we stressed that, while a number of important issues have been resolved, there are still several concerns which need to be addressed: in particular, the relationship of the provisions on the exemption from the shareholding notification duty for market-makers with MiFID; notifiable derivative instruments; aggregation between different kinds of notifiable holdings; and contents of half-yearly financial statements.

Transparency Directive: longer-term priorities

Discussions about the Directive implementing the Transparency Directive and about the implementation of the transparency regime in the UK have helped to identify some issues which cannot be resolved at Level 2 or at national level. The most important of them

is the alignment of the prospectus and transparency regimes: it is becoming clear that some products or issuers benefit from a lighter regime or an exemption under the prospectus regime without it being carried over to the transparency regime. The possible equivalency of shareholding notification regimes of non-EEA countries will require further consideration and so will the issue of liability for disclosures made under the Transparency Directive. Detailed comments can be found in our response to the formal draft of a Directive implementing the Transparency Directive (see above).

Calculation agency role in derivatives

Together with ISDA, we have published an [explanatory note](#) on the calculation agency role with respect to derivative-linked securities. The role of a calculation agent with respect to both the securities and any related hedge is essential. The rapid growth of the sector has, however, highlighted the need for a better market understanding of all the implications of the calculation agency role. The explanatory note focuses on three aspects of the role. First, it addresses the need to identify as early as possible who is to be the calculation agent in relation to the securities and allow adequate time to agree the terms of its appointment. Second, it emphasises the need for clarity as to the role and responsibilities of the calculation agent. Finally, it discusses the interrelationship between the derivative securities and any related hedge, particularly where the hedge provider is also calculation agent under both the hedge and the derivative securities.

"Senior" and the "negative pledge" covenant

ICMA is an active participant in the discussions between the sell side and investors on the timeliness and accuracy of disclosure and clarity of covenants in the primary market. We have already published several

Issue no. 3: October 2006

recommendations concerning availability of offering documentation to investors. In the course of these discussions, some institutional investors raised concerns about the difficulty in understanding certain terms and covenants used in the documentation of bond issues, in particular "senior" and the "negative pledge" covenant. We recognise that market practices regarding these two concepts are not always uniform and support any efforts to promote better understanding among investors of existing practices. So we will shortly be publishing on our website an explanatory note providing a brief, non-technical explanation of "senior" and the "negative pledge" covenant, as usually used in practice at present.

UCITS implementing measures

ICMA has continued to be involved – with members of our ECP Committee – in the negotiations on the Commission's proposed implementing measures on UCITS. The Commission came forward with a [revised proposal](#) for discussion at the European Securities Committee on September 13, with a view to reaching agreement before the winter.

New Global Note

The New Global Note (NGN) structure was launched on June 30, as planned, and the ECB announced that the NGN structure had been "positively assessed". In order to give more time for issuers to prepare for the changeover to the NGN from the Classical Global Note (CGN) for new issues in global bearer form intended to be eligible for Eurosystem collateral, the ECB has also announced that new issues using the CGN will be "grandfathered" – for Eurosystem eligibility purposes – until December 31, 2006. After that, only new issues using the NGN structure will potentially be eligible as Eurosystem collateral. The [NGN documentation](#) on the ICMA website has been updated, and

the next step is expected to be to complete – with the other parties involved – a Standard Market Protocol as a set of market guidelines to help users of the NGN and CGN.

STEP

The Short-Term European Paper (STEP) initiative was launched by the President of the ECB in Frankfurt on July 11. It is designed to help promote the integration of short-term European paper markets. The STEP secretariat is willing to grant a STEP label for short-term paper issues, provided that: the information memorandum is presented in a common format for publication on the STEP website; and that the issuer agrees that statistics can be collected to meet requirements set by the ECB. A STEP label may help achieve Eurosystem eligibility for short-term paper which is not currently eligible, provided that the Eurosystem's other criteria are met. The ECB issued a [press release](#) on September 15.

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Issue no. 3: October 2006

Other ICMA news

ICMA launches TRAX2

TRAX2 is ICMA's one-stop trade matching and regulatory reporting system. It has been developed in conjunction with ICMA members and market users as an operational risk management and regulatory reporting tool. TRAX2 performs post-trade matching and post trade transaction reporting in a wide range of instruments, including bonds, equities and derivatives (CFD's, futures, options and more). It is designed to be sufficiently flexible to assist financial institutions in meeting their regulatory reporting requirements under MiFID in addition to allowing them access to new repo matching capabilities for the first time.

TRAX2 builds on the success of the original TRAX system, which has been operating successfully since 1989. It currently has over 200 subscribers and processed over 34 million transactions in 2005 alone.

TRAX2 new repo functionality is now live and being used by a number of major market participants, including Goldman Sachs International, J.P. Morgan Securities Ltd, Nomura International plc, and Credit Suisse Securities (Europe) Ltd, to

manage operational risk in the repo market.

Post-trade transparency for the international bond market, already a feature of TRAX is incorporated in TRAX2, with subscribers having access to daily end of day data on prices and volumes traded through the system. (This data is also available directly from ICMA and through data vendors)

For more information on TRAX2 speak to a member of our business development team - telephone +44 20 7538 5656 - or visit www.Trax2.org

ICMA European repo survey shows market size in excess of EUR 6 trillion

ICMA released the results of its [11th semi-annual survey](#) of the European repo market on October 4, 2006. The survey, which is effectively a snapshot of the volume of repo trades outstanding on a single day in June, shows market size standing at over EUR 6 trillion, a 15 % increase from June last year.

The total value of repo contracts outstanding on the books of the 79 institutions who participated in the latest survey was EUR 6,019 billion, compared to EUR 5,883 billion in December 2005 and EUR 5,319 billion in June 2005.

Forthcoming ICMA events

[Securities offerings and listings in Ireland](#)

October 25, 2006
London Stock Exchange,
London

[MiFID - what does it mean for Switzerland?](#)

Three seminars will be held as follows:

November 9, 2006
SWX Conventionpoint,
Zurich

November 13, 2006
Dante Hotel, Lugano

November 14, 2006
Mandarin Oriental Hotel,
Geneva

[ICMA Primary Markets Certificate \(PMC\) Programme](#)

November 20-25, 2006
MWB Business Exchange,
London

[ICMA-ACI Professional Repo Market Course](#)

November 22-23, 2006
Hesperia Hotel, Madrid

[ICMA Luxembourg MiFID Seminar](#)

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