

**MiFID: FSA DISCUSSION PAPER ON BEST EXECUTION (DP 06/3):
RESPONSE FROM BMA/ICMA/ISDA: SUMMARY**

The FSA's decision to issue DP 06/3 to encourage industry debate before formally consulting later in the year on best execution is most welcome. So is the FSA's pragmatic approach to execution policies and arrangements in Chapter 2. However, the status and scope of the benchmarking proposal in Chapter 3 need further clarification before its impact can effectively be assessed. As regards status, Chapter 3 implies that "robust" price benchmarking is the only valid means of achieving and demonstrating best execution. No other options are put forward. As regards scope, the fundamental issue of what constitutes the execution of a client order is not answered.

Is benchmarking necessary?

Dealer markets are very competitive. There is no evidence of a market failure to justify the benchmarking proposal. Nor has there been any industry input into the IBM Paper. As a result, most of its assumptions are flawed. The benchmarking proposal is not consistent with the FSA's commitment to principles-based regulation and "intelligent copy-out". Nor is it consistent with MiFID Article 21 on best execution. Indeed, Chapter 3 of DP 06/3 is not consistent with Chapter 2. On conflicts of interest, DP 06/3 is inconsistent with other FSA analysis and out of touch with the way dealer markets operate. The benchmarking proposal is also inconsistent with practice and regulation in global markets (eg in the US). And the proposal is distracting attention from implementing MiFID. Many firms have stopped work on planning how to implement MiFID's best execution provisions.

Would benchmarking work?

The benchmarking proposal is based on the erroneous premise that there is a continuously executable price available from a predominant source of liquidity in dealer markets. There are no "robust" benchmarks for most fixed income products, and benchmarking is incompatible with OTC derivatives and structured products. In the limited areas where benchmarking would in theory be feasible, it is not necessary, as prices are already visible to most dealers and professional investors, and benchmarking would be expensive to implement in practice. It is not possible to monitor benchmarks in any meaningful way. The benchmarking proposal altogether fails to reflect the economic function of dealer markets.

What would be the implications of benchmarking?

If benchmarking were imposed, there is 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. Nor would benchmarking directly benefit retail investors, whose access to the market is through intermediaries. There would also be a risk of mis-selling: benchmarking would provide only spurious accuracy. Consequently, the costs and risks of the benchmarking proposal far outweigh any benefits.

Is there an alternative to benchmarking?

There is 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.

14 July 2006

MiFID: FSA DISCUSSION PAPER ON BEST EXECUTION: RESPONSE FROM BMA/ICMA/ISDA

Introduction

1 The Bond Market Association (BMA), the International Capital Market Association (ICMA) and the International Swaps and Derivatives Association (ISDA) are grateful for the opportunity to respond to the FSA's Discussion Paper, *Implementing MiFID's best execution requirements* (DP 06/3). Our response, which is joint, focuses on those parts of DP 06/3 most relevant to over-the-counter (OTC) dealer markets, in which dealers act as principals on their own account¹: the benchmarking proposal in Chapter 3, including the related IBM Global Business Services White Paper, *Options for providing best execution in dealer markets* ("IBM Paper"); and the section specific to dealer markets in Chapter 4. The response has been prepared, in collaboration with the London Investment Banking Association (LIBA), by a working group involving twenty market firms responsible for the vast majority of transactions in bond, derivatives and structured products markets in the UK, the EU and globally.

Preliminary issues

2 There are two preliminary issues which the FSA has left unanswered, but which are fundamental to a full assessment of the benchmarking proposal. One relates to the status of the proposal, and the other to its scope.

(i) The status of the benchmarking proposal

3 The proposal on benchmarking is put forward in Chapter 3 as an option by means of which firms could demonstrate best execution. For example, in paragraph 3.19, the FSA says that "we are seeking further discussion with industry on whether it could be a useful additional option for firms". But much of the language of Chapter 3 implies that "robust" price benchmarking is the *only* valid means by which dealers could consistently achieve best execution, and demonstrate that they have done so. No other options are put forward in Chapter 3. Indeed, the IBM Paper states: "We have given some consideration to whether there are viable alternatives to the benchmark modelling approach outlined here. ... We do not believe there are."² In our view, it would be quite wrong, and inconsistent with the proportionate and practical approach that FSA sets out in Chapter 2, to limit firms' options in the way that Chapter 3 proposes.

(ii) The scope of the benchmarking proposal

4 The scope of benchmarking would depend on what constitutes the execution of a client order. But DP 06/3 avoids answering this fundamental question³. For the reasons set out in LIBA's response to DP 06/3, we think that it would be correct for the FSA to interpret MiFID and its Level 2 measures as follows: "the consequence of interpreting 'order' and 'executing a client order' in line with MiFID is to exclude, from best execution obligations, any dealing on own account where the firm does not act on behalf of, or otherwise owe an agency or similar contractual obligation to, a client. Any dealing with market participants where the firm does not act on behalf of the client, thereby owing the client agency or similar contractual obligations, cannot under MiFID be considered as executing a client order, and so cannot be subject to best execution obligations. This is as it should be, since the bulk of activity in dealer markets involves market participants who choose to deal with the dealer on a principal basis, and do not expect the firm to owe them an agency obligation."⁴

¹ Most paragraphs should be read as applying equally to OTC derivatives and structured products as well as to bonds. But a number do apply purely to one or the other. While any instance should be clear from the context, we have tried to include a signpost wherever necessary.

² IBM Paper, #2.5

³ "DP 06/3, #3.9 and footnote 9

⁴ LIBA response to DP 06/3. Recital 33 of MiFID itself states that the best execution obligation should apply where contractual or agency obligations are owed.

5 While DP 06/3 does not answer the question of what constitutes a client order, it does inappropriately limit the requirement in MiFID to follow client instructions. We agree with LIBA's recommended interpretation of the provisions on client instructions in MiFID: "FSA should interpret 'specific instruction from the client' as covering any circumstance where, in giving an order or specifying a course of action that the firm should take when executing the client's orders over an extended period, the client specifies any aspect of how, where, when, or with whom it wishes the firm to execute the order or orders. Anti-avoidance provisions should be restricted, in accordance with the copy-out approach, to the circumstances set out in MiFID Level 2 Recital 68 only."⁵

Assessment of the benchmarking proposal

6 We have organised our response to DP 06/3 into *four main sections*:

- Is benchmarking necessary?
- Would benchmarking work?
- What would be the implications of benchmarking?
- Is there an alternative to benchmarking?

7 There are *three annexes* supporting our response.

- At Annex A, we list the assumptions in the IBM Paper, and in each case give the views of our working group members (several of whom are responsible for e-business operations in their firms) on whether the assumptions are true or false.
- At Annex B, we include a short paper on fundamentals of bond, derivatives and structured products markets as an integral part of our response.
- At Annex C, we provide brief answers to all the FSA's questions in DP 06/3, with cross-references to our response, where appropriate.

(i) Is benchmarking necessary?

There is no evidence of a market failure to justify the benchmarking proposal

8 No market failure analysis on the provision of best execution in dealer markets has been undertaken by the FSA to demonstrate a need for benchmarking of best price. Nor is there any evidence of a market failure in price transparency, to which the benchmarking proposal relates. In the absence of a market failure being demonstrated, we believe that competition – and not additional regulation – continues to be the best way of ensuring that best execution is achieved in the fixed income and derivatives markets, which are institutional rather than retail.

9 Little consideration seems to have been given by the authors of Chapter 3 to: (i) the FSA's own Discussion Paper, *Trading transparency in the UK secondary bond market* (DP 05/5) and industry responses reflected in the FSA Feedback statement (FS 06/4)⁶; (ii) recent independent research, which highlights the overall efficiency and competitive nature of the EU bond markets and does not find evidence of a market failure in the provision of

⁵ LIBA response to DP 06/3

⁶ "... We do not see any evidence of substantial market failures related to transparency in wholesale bond markets based in the UK. We agree with the view of the majority of respondents that a combination of competition, market-driven transparency, the interaction between cash and credit derivatives markets, and regulation seems sufficient, in general, to deliver efficient pricing and fair execution" (FS 06/4, #1.7).

best execution or price transparency⁷; or (iii) the important role that OTC derivatives and structured products play in corporate risk management and in the efficient transfer and allocation of risk generally.

10 This suggests either that the authors of Chapter 3 are not prepared to take proper account of the economics of fixed income and derivatives markets or that there is a separate agenda to turn them into quasi-agency markets. If such a fundamental transformation of the market under MiFID had been intended, it should surely have been flagged at an earlier stage.

There has been no industry input into the IBM Paper

11 In its executive summary, IBM says: “As agreed with the FSA, our work on this project has been completed without direct input from the industry.” Initial concerns – including concerns about a possible benchmarking proposal – raised by several trade associations in informal bilateral meetings with the FSA prior to the publication of DP 06/3 have been ignored. As a result, the majority of the assumptions made in the IBM Paper are flawed (see Annex A for a detailed analysis).

12 We are therefore particularly concerned that the FSA is commending DP 06/3 to the Commission and CESR as “a useful resource for implementation discussions”.⁸ By commending the benchmarking proposal in this way, the FSA appears to be pre-judging, not only the conclusions it will reach before it has received any industry input on DP 06/3, but also those that the Commission will reach in its Article 65 report on price transparency, despite the FSA’s previous statement in DP 05/5 that it would not do so.⁹

The benchmarking proposal is not consistent with the FSA’s commitment to principles-based regulation and “intelligent copy-out”

13 The FSA is committed to principles-based regulation¹⁰, and the Chancellor in his Mansion House speech committed the Government to a regulatory environment which is “predictable and light touch”.¹¹ These commitments are not carried out in the case of Chapter 3. On the contrary, the FSA appears to be proposing to micro-manage the relationship between firms and their clients, including professional clients, which is contrary to both the spirit and the letter of MiFID. Indeed, Chapter 3 is inconsistent with the principles laid out in Chapter 2.

14 The FSA is also committed to “intelligent copy-out” of EU Directives.¹² Chapter 3 proposes to go way beyond “intelligent copy-out”, without establishing evidence of market failure or conducting a cost-benefit analysis, and in contravention of the copy-out approach implicit in Chapter 2. It is not at all clear that the benchmarking proposal is consistent with Article 21 of MiFID on best execution (see #15 below). There is nothing in the Level 1 or Level 2 measures that requires the use of benchmarking in the way in which Chapter 3 proposes. The benchmarking proposal also appears to be gold-plating MiFID, which

⁷ CEPR reports on transparency, liquidity and efficiency of European government and corporate bond markets (May 2006)

⁸ DP 06/3, #1.13

⁹ “We would propose introducing new transparency requirements for the trading of bonds in the UK only in response to an identified market failure. And in any event we do not intend proposing changes to our regulations ahead of the outcome of the Commission’s review.” (FSA DP 05/5, #7.1)

¹⁰ eg John Tiner: “I believe that we should move to a more principles-based approach”: 9 May 2006.

¹¹ The Mansion House speech, 21 June 2006. Callum McCarthy also said on 21 June 2006: “Any sensible regulator, ... certainly the FSA, believes that the best outcomes for both producer and customer come from efficient markets, not from regulation. You should therefore expect measures which work with the grain of the market... ”

¹² Hector Sants: “Our approach to implementation is intelligent copy-out of the MiFID text, with requirements tougher than the Directive only where this can be justified by cost-benefit analysis.”: 25 July 2005.

would be incompatible with Article 4 of the Implementing Directive. We do not consider that it would be justified in this case to treat such gold-plating as “exceptional”.

The benchmarking proposal is inconsistent with MiFID Article 21 on best execution

15 There are at least six factors to be taken into account in the best execution requirements in Article 21 of MiFID, in cases in which best execution applies. Chapter 2 of DP 06/3 stresses this point on several occasions. By contrast, Chapter 3 focuses only on best price and offers benchmarking as a means of obtaining best execution, as an alternative to interposing an agency broker model or dealing only with eligible counterparties. This focus on best price in markets that are overwhelmingly wholesale is inconsistent with MiFID Article 21, as well as with the way in which such markets operate (see Annex B). There are clearly other means of obtaining best execution which the FSA has not discussed. So presenting the benchmarking proposal as the only option for dealer markets on the grounds that the only other options under MiFID are to avoid best execution (#3.13 of DP 06/3) is misleading.

The analysis of conflicts of interest in DP 06/3 is inconsistent with other FSA analysis and out of touch with the way dealer markets work

16 First of all, the conflict of interest analysis in DP 06/3 runs counter to the FSA's Consultation Paper (CP 06/9), *Organisational systems and controls* (SYSC), which is based on straight “copy out”. The two are inconsistent. SYSC correctly states that there needs to be a duty to the client before a conflict of interest exists (and that making a profit does not *per se* imply a conflict).

17 Second, there is no substance to the allegation in #3.16 of DP 06/3, based on information asymmetries, that dealers take advantage of their clients.¹³ Professional investors are at least as well informed as, and often better informed than, dealers, since each individual dealer may know only what it is quoting to a client, while a client with access to multiple dealers can take a broader view (see Annex B #7). It is professional investors who choose between various dealers (ie “execution venues”) rather than the other way round.

18 Third, where conflicts of interest do arise, the FSA has itself argued that good policy-making should focus on how best to manage such conflicts. The benchmarking proposal goes much further by attempting to eradicate conflicts altogether. This is inconsistent, unrealistic and disproportionate.

19 Fourth, dealers operate as principals in extremely competitive markets in which, therefore, client relationships and reputation matter. If a dealer, in providing quotes, were to take solely the short term view of its interests portrayed by the FSA, it would be likely to lose the client. As a result of the competitive environment, there has been a reduction in dealer spreads over the years across all market segments (see our response to Assumption 25 of Annex A). The FSA's own analysis in FS 06/4 confirms this¹⁴, and the authors of Chapter 3 of DP 06/3 should take it into account.

The proposal is inconsistent with practice and regulation in the global markets (eg in the US)

20 The FSA benchmarking proposal is out-of-step with corresponding NASD regulations both in the scope and substance of its proposals on best execution, which creates

¹³ “We are not clear that existing differences in the availability of trading information to different types of institutional participant reflects a market failure *per se*, as in any market there will be those participants with better access to information than others. This is a consequence of how markets function, and the nature of the role that particular participants play.” (FS 06/4, #4.13.)

¹⁴ FS 06/4, #3.10, which concludes: “Our analysis, while limited, does not provide any particular indication that dealers are able to systematically buy bonds at one price and sell at a notably higher price.”

significant legal, compliance and operational risks for financial services firms operating globally.

- NASD's best execution Rule 2320(a) states in paragraph (f): "The obligations described in paragraphs (a) through (e) above exist not only where the member acts as agent for the account of his customer but also where retail transactions are executed as principal and contemporaneously offset. Such obligations do not relate to the reasonableness of commission rates, mark-ups or markdowns which are governed by Rule 2440."
- Rule 2440 in turns states that: "In over-the-counter securities transactions ..., if a member buys for his own account from his customer, or sells for his own account to his customer, he shall buy or sell at a price which is fair, taking into consideration all relevant circumstances, including market conditions with respect to such security at the time of the transaction, the expense involved, and the fact that he is entitled to a profit; and if he acts as agent for his customer in any such transaction, he shall not charge his customer more than a fair commission or service charge, taking into consideration all relevant circumstances, including market conditions with respect to such security at the time of the transaction, the expense of executing the order and the value of any service he may have rendered by reason of his experience in and knowledge of such security and the market therefor."

21 In September, 2005, the NASD filed Amendment No. Rule 2320 with the Securities and Exchange Commission for the purpose of clarifying its members' duties with respect to best execution in any transaction "for or with a customer of another broker-dealer". Amendment No. 4 states that a NASD member firm's duty to provide best execution "does not apply when another broker-dealer is simply executing a customer order against the member's quote" and that "the duty to provide best execution to customer orders arises only when an order is routed from the broker-dealer to the member for the purposes of order handling and execution". Amendment 4 remains deficient in so far as it fails affirmatively to include situations where the order is presented by the customer himself (not only by the customer's broker-dealer). However, it does support the fundamental premise that best execution is strictly an agency concept by clarifying that a dealer does not owe best execution to the customer of another dealer in instances where it is simply providing quotes acting in a principal capacity. In addition, the NASD Rule does provide for additional protections to retail investors (as does MiFID).

22 Therefore, in its current iteration, the obligation to provide best execution in both US equity and fixed-income markets¹⁵ exists where a member firm acts as agent for the account of any customer and where retail transactions are executed as principal and simultaneously offset (ie riskless principal transactions). When it comes to price, the obligation on principal dealers is to provide a fair price and the obligation on agents to charge a fair commission. Subject to the deficiency highlighted above, we believe that this is the correct approach. It is also consistent with our analysis of scope in #4-5 above.

The proposal is distracting attention from implementing MiFID

23 Finally, the benchmarking proposal is distracting scarce resources from the essential task of implementing MiFID on time. Many firms have also stopped work on planning how to implement MiFID's best execution provisions, because they consider that implementing this proposal is not practicable and because DP 06/3 puts a question mark over other acceptable methods of complying.

(ii) Would benchmarking work?

24 The FSA makes the assumption that benchmarking will work, though the IBM Paper says that, in the case of illiquid or complex products, there are no external benchmarks.

¹⁵ Derivatives are excluded, other than stock options.

Instead, reliance would have to be placed on firms' internal models. But the FSA is "predisposed against reliance on internal models".¹⁶

25 In order to analyse whether benchmarking would work, it is important to emphasise the diversity of the different segments of the fixed income and derivatives markets. Fixed income and derivatives products exist in a continuum ranging from:

- (i) listed and exchange-traded products, which (in the case of bonds) represent less than 1% of the total; to
- (ii) liquid cash bonds and "plain vanilla" derivatives, some of which may be transacted on electronic trading platforms (which should not be confused with exchanges); and
- (iii) everything else (the vast majority in the case of both bonds and derivatives).

26 It is important also to clarify what we mean by "benchmark" in this response, given the variety of uses of the term in the market. The FSA describes the ideal benchmark as one that needs to be "robust" for the purposes of achieving best execution. The key determinants of a robust benchmark would be that: (a) it must "be an accurate reflection of real prices for the relevant instrument"¹⁷ and (b) it would be "drawn directly from a relevant pool of liquidity"¹⁸.

27 The quality of a benchmark of that kind is based on the following four factors:

- the number of dealers making markets;
- the frequency of price updates;
- the firmness of the price; and
- the size for which the price is firm.

This is therefore the context in which we assess the feasibility of the FSA's proposal on benchmarking in Chapter 3.

There are no "robust" benchmarks for most fixed income nor for any OTC derivatives and structured products

28 On that basis, there are no "robust" benchmarks for most fixed income products, and benchmarking is incompatible with OTC derivatives and structured products. This is because the benchmarking proposal is based on the fundamentally erroneous premise that there is a continuously "real" common price, available from a predominant source of liquidity, for instruments traded in dealer markets. That is not the case for most of the instruments traded in these markets, as explained in detail in Annex B. Benchmarking would be feasible in theory for the instruments listed in #25 above in category (i), and possibly for the most liquid securities listed in category (ii), where dealers provide continuous firm quotes. However, for the vast majority of instruments in the fixed income and derivatives markets (both in terms of number of trades and volumes), there are no "robust" externally verifiable benchmarks.¹⁹

¹⁶ DP 06/3, #3.39

¹⁷ DP 06/3, #3.24

¹⁸ DP 06/3, #3.25

¹⁹ There are 110,000 bonds on CUPID, of which 10,000 are government bonds. Of the remaining 100,000 corporate bonds, 8% are traded on IDBs, but only 3% on ECNs. Benchmarking would only theoretically be feasible in the case of 3,000 corporate bonds. IBM's conclusion that 92% of bonds in TRAX have ECN and IDB prices is not relevant, as ECNs and IDBs quote bonds in which there is potential trading activity as a result of dealer and client interest, and those transactions are reported post-trade to TRAX.

29 IBM is therefore correct to state that there are no external benchmarks in the case of the great majority of bonds and derivatives and that, to obtain a benchmark, it would be necessary to rely on internal models. However, internal models could not in practice be used as benchmarks. It would not be possible to construct a meaningful benchmark against price (and size) by breaking down the constituent parts of an illiquid or complex product. Even the limited number of “vanilla” bonds which are liquid and traded on ECNs are diverse, making any formulaic benchmark virtually meaningless.

30 IBM does not set out the basis for determining which type of benchmark to use in which circumstances. Different firms have different models even for plain vanilla products; and different benchmarks would be used by different firms for the same asset, depending (say) on size and liquidity, and potentially resulting in at least three different available reference prices: an ECN-based reference price; an IDB-based price; and internal model-based prices. Over the trading pattern of its life, a security may change dynamically to fit into one or other of these frames of reference. Much of the IBM analysis is, however, based on the assumption that reference prices would be identical and that competition thereafter would affect only the size of the dealer spread. This assumption is wrong. Even where dealers and institutional customers use the same pricing model, the model often involves several different inputs; different parties can use different inputs and derive different valuations using the same model.

In the limited areas where benchmarking would in theory be feasible, it is not necessary and would be expensive to implement in practice

31 Benchmarking would in theory be feasible in the case of exchange-traded and highly liquid bonds traded on IDBs and ECNs. However, the universe of highly liquid bonds is diverse and their liquidity profile can vary over time: most bonds are liquid, if ever, only for the few days or weeks after issue.²⁰ In addition, in the case of highly liquid bonds, prices are visible to most dealers and professional investors, and consequently there is already a standard for best price without the straitjacket of a benchmark. Finally, we disagree with IBM that implementing benchmarking would be cheap in the more liquid products. We believe that benchmarking would be expensive to implement in practice (see Annex A).

OTC derivatives are incompatible with benchmarking

32 In the case of OTC derivatives (see Annex B for a detailed description), the “instrument” does not even exist unless and until a strictly bilateral contract is concluded between the counterparties. Even in their most commonly written form, OTC derivatives are therefore, in concept, fundamentally incompatible with the benchmarking approach. MiFID requires that the diversity of different products should be taken into account in its approach to best execution.²¹

33 Although some OTC derivatives are loosely referred to as “liquid”, the instruments themselves are never transferred. Any appearance of fungibility – and therefore liquidity – in OTC derivatives is just that: appearance. The key to a customer’s ability to transfer risk through OTC derivatives depends on the willingness and ability of a dealer to stand as principal to the contract. The extent to which dealers are able to offset this risk will depend on other parties themselves acting as principal. In practice, the degree of offset can vary considerably, and will rarely be perfect. This characteristic extends to instruments such as structured notes, which consist of a combination of derivatives and other instruments, typically bonds.

²⁰ This was accepted in the DP 05/5, but has not been taken into account in DP 06/3.

²¹ “ ... Best execution obligations should ... be applied in a manner that takes into account the different circumstances associated with the execution of orders related to particular types of financial instruments. For example, transactions involving a customised OTC financial instrument that involve a unique contractual relationship tailored to the circumstances of the client and the investment firm may not be comparable for best execution purposes with transactions involving shares traded on centralised execution venues.” (MiFID Level 2 Directive, Recital 70)

34 Since OTC derivatives are bilateral contracts which incur credit exposure, benchmarking would require adjusting a transacted price for the implied credit spread of the counterparty before applying this credit-adjusted price to a non-existent benchmark price. As the process becomes more and more complex, it becomes less and less meaningful.

35 It is important also to distinguish between benchmarking and “price verification”, which is used by some firms for OTC derivatives. Firms engaged in risk control of their OTC derivatives positions do in some cases feed prices into a central facility, which then makes aggregate information available to the participants. Such information is typically end-of-day only, and not in any case intended for live transactions.

Structured products are also incompatible with benchmarking

36 The assumption that benchmarking can be applied generally to structured products is misguided. It is generally not possible or desirable for a firm to hedge or price every component of a structured product individually; and it is not clear that a fixed structuring commission or spread limit is practicable, as it assumes that different markets have the same and/or constant volatility. Moreover, where structured credit products are concerned, the tranching process creates unique combinations of underlying assets with specific structures that are extremely difficult to hedge since by definition they are custom-tailored. In other words, a benchmark used to reference a specific deal is unlikely to be comparable, since the collateral and structure is unlikely to be identical. In any form of structured product, the problems with the benchmarking approach would be acute, and applying it to the component parts would merely compound the problem (see Annex B).

Spread-betting is not a precedent

37 Spread-betting and CFDs represent a small part of the market where benchmarking might be made to work, for contracts based on liquid exchange-traded equities and offered in retail size, though that would not necessarily mean that this would be desirable. We understand that spread-betting firms are concerned about the loss of their exemption from best execution.²² An alternative approach would be to impose MiFID’s suitability and appropriateness requirements, and the venue selection factor set out in Article 44(1)(d). In any case, imposing benchmarking on the market as a whole because it might work in a small market segment would be like using a sledgehammer to crack a nut.

It is not possible to monitor benchmarks in any meaningful way

38 Since it is not possible to construct robust benchmarks in most dealer markets, there is no robust benchmark against which to monitor prices (see Annex C, Q4.5). If benchmarking is imposed on certain sectors of the market, it is not clear how dealers could monitor the benchmarks in real time. IBM makes the specific point that post-trade transparency would not solve this problem. It says that benchmarking would only work with pre-trade benchmarks. A pre-trade price could only be used as a guide price, as many such prices could not be executed. Existing pre-trade ECN prices are only seen by buy-side customers. If the sell side were to see them, this would be a substantial change in market practice. There would also be a potential problem if a change in the benchmark lagged changes in individual dealer quotes. To this extent, the benchmark price might be better or worse than the actual price prevailing in the market.

The benchmarking proposal fails to reflect the economic function of dealer markets

39 The benchmarking proposal fails to reflect the economic function of dealer markets in which firms act as principals. This is evident from the FSA and IBM discussion of bid-offer versus mid-price reference prices and the proposed separate arrangements for charging commission (see also Annex B).

²² FT, 23 June 2006

40 In an order-driven market, “natural” buyers and sellers have an investment view that they wish to buy/sell a particular instrument. A dealer has no fundamental view of the market. The dealer is merely a facilitator/liquidity provider. For whatever it buys or sells, the dealer looks to reverse that transaction as quickly as possible. The dealer charges the investor as compensation for the risk of taking on a position which, but for the dealer, the investor would have had to retain itself.

41 This charge is reflected in the dealer spread.²³ When markets become volatile or liquidity decreases, the spread increases. This is because of the additional risk that the dealer may incur a loss in reversing the transaction. Hence a dealer spread is qualitatively different from charging a commission to execute a client order on an order book. In the former case, there is an additional facility provided by the firm in assuming the risk which would continue to be held by the buyer/seller in the absence of the dealer. In the latter case, the firm takes on no position risk in executing an order between two investors.

42 Therefore, in terms of the two different options presented (bid-offer and mid-point) as possible reference price for the benchmark, dealers do not deal at the mid-point. A quote given by a dealer takes account of a wide range of variables, including the dealer’s own position and risk appetite. The result cannot be compared with an artificial benchmark price extracted from the data, even if data are readily available.²⁴

43 Even in order book trading, trades are not executed at the mid-point between the bid and offer. An investor wishing to trade at better than the existing bid/offer may attempt to do so by entering a limit order improving the side of the market it wishes to be on. However, it does this at the risk of the market moving away, and thus having to accept a transaction at a worse price than the one existing prior to it entering a limit order, or worse, at the risk of not being able to execute at all. Dealer markets provide immediacy, the price of which is included in the dealer’s spread.

44 However, using best bid-offer is problematic too, especially for illiquid products which have fewer dealers – and sometimes only one dealer – giving quotes, but also in times of market stress.²⁵

45 Similar considerations to the fixed income markets apply in the OTC derivatives and structured markets (see Annex B).

Conclusions on feasibility

46 In sum, the robustness of a benchmark will depend on four main factors:

- the number of dealers making markets: this varies, depending on the nature of, and demand for, the product;
- the frequency of price updates: this varies by firm and by instrument (in the case of some securities ranging from “real time” to monthly, and in the case of OTC derivatives only at the point of contracting – see Annex B);

²³ As bond dealers are not in general rewarded via commission, market users pay for this access to dealer liquidity through the dealer’s bid-offer spread.” “... Where dealers compete to make markets the bids and offers quoted still need to be sufficiently competitive to attract order flow.” (DP 05/5, #2.29-30)

²⁴ “The size of spread that might indicate an inefficiency is complex to assess (especially for infrequently traded bonds), and in any event spreads vary considerably between instruments and over time. The position may be further complicated by any cross-subsidisation between firms’ market making and other business lines ...” (DP 05/5, #5.7)

²⁵ “In times of market stress ... liquidity is not well measured by bid-ask spreads, not least because it is highly variable. ... the quoted spreads are often not representative of the spreads that market participants are paying.” ECB Occasional Paper, *Implications for liquidity from innovation and transparency in the corporate bond market* (April 2006 draft, page 15). And “... in a high risk, volatile market, the optimal behaviour of dealers may be to maintain wide spreads, thereby still offering liquidity to the market but without adopting excessive levels of risk.” (FS 06/3, #4.4)

- the firmness of the price: this, too, is variable, including in liquid bonds traded on ECNs²⁶; and
- the size in which the price is firm, which is also variable.

Since there is no consistency in any of these four factors, this will invariably reduce the quality of the benchmark.²⁷

47 Given that the benchmark model is (i) inapplicable or unworkable in very large parts of dealer markets; and (ii) would only work in theory in the case of instruments which are already very transparent and liquid throughout their life (ie are already in effect used as “benchmarks”)²⁸, the cost-benefit of implementing such a model seems wholly unjustified.

(iii) What would be the implications of benchmarking?

48 What would be the implications if benchmarking was imposed on the market in a situation in which a dealer was executing a client order?

Impact on dealers’ customers

49 Firms could in theory avoid the possibility of benchmarking by dealing only with eligible counterparties (ECP).²⁹ But in the case of most firms, this would not appear to be commercially practicable.³⁰ In other cases, regulatory limitations would proscribe dealing with certain clients as ECPs. Even if it were practicable to deal only with ECPs, and firms took advantage of this to avoid benchmarking, that could have an adverse effect on the liquidity available to non-ECP clients of the dealer. As benchmarking would only be feasible in theory for a narrow group of instruments, firms would be likely to withdraw from providing liquidity to non-ECP clients in a large number of instruments. In addition, companies – especially SMEs – would be deprived of valuable risk management facilities in the form of OTC derivatives.

Impact on liquidity

50 If a benchmarking model was imposed, any dealers wishing to carry out a trade would need to trade inside the benchmark price in order to capture the trade from the competition. This would potentially compress spreads (though see the section on “Impact on investors” below), and undermine the willingness of dealers to trade in large sizes.³¹

²⁶ eg on 15 June, in cash bonds available on Bloomberg, only 66% of the volumes transacted were done at prices quoted as firm.

²⁷ eg a reasonably liquid corporate bond such as REW 6.125 12 has up to 30 dealers making markets, in sizes from 100,000 to 5 million, some two-way, some one-way, some firm, some indicative.

²⁸ “We tend to agree with the majority of respondents that greater transparency for benchmark bonds would offer little additional benefit.” (FS 06/4, page 35).

²⁹ There is also a question about whether “eligible counterparties” will be defined in different Member States in the same way. Some Member States may not allow corporates to act as such.

³⁰ There are a number of reasons for this: (i) it may not always be possible to classify a professional client as an ECP; (ii) some entities may simply be unwilling to be classified as ECPs; (iii) even if the counterparty is willing for some purposes, firms may wish to avoid dual classification of counterparties (ie ECP counterparties for some purposes and professional clients for others); and (iv) size criteria for classifying entities as professionals or ECPs may exclude ECPs.

³¹ “Market efficiency is not just about the tightness of spreads. The sizes quoted are also of importance. Where competition exists between dealers pricing improves. But prices and quote sizes may react differently to increases in transparency, with quoted spreads tightening while the size quoted falls.” (FS 06/4). See also the speech by Malcolm Knight, General Manager of the BIS, on *Promoting liquidity in domestic bonds markets* (May 2006): “Even though bid/offer spreads in some parts of East Asia appear at first sight to be quite narrow, this may partly reflect government or exchanges rules that constrain market makers’ spreads. These rules can undermine the willingness of market makers to deal in size, so the cost of this apparent liquidity may in fact be a reduction in market depth.”

Given the significant implementation costs also involved, there is a very real risk that dealers would withdraw liquidity from benchmarked instruments, in particular those dealers in inventory-driven markets, because of the costs and risks and the increase in disclosure involved (see Annex A). This would undermine the composite benchmarks concerned, which would then cease to be useful (ie an example of Goodhart's Law). Although benchmarking may be feasible in theory in the case of highly and continuously liquid bonds, the effect of introducing it could be to reduce liquidity across the market as a whole. At the very least, this risk should be properly discussed and analysed over an extended period and not disregarded in order to impose detailed rules in the very limited period available for implementing MiFID.

51 The impact on liquidity would be similar in the OTC derivatives market. An attempt to introduce benchmarking would reduce the willingness of firms to make capital available to support risk transfer. This would have a clear knock-on effect on SMEs in the real economy. Large corporates would qualify as "professional" under the client categorisation in MiFID, and could therefore opt to become ECPs.

52 The impact on liquidity in the structured product markets would also be similar. Liquidity is a major factor in pricing structured products affecting key questions: how quickly and cheaply; and to what extent the dealer can hedge his risks. This is a matter of judgment and difficult to justify empirically. The dealer will quote different prices under different market conditions for the same internal model price. Therefore, not only are internal models of little value as benchmarks, but also the liquidity in those products would be likely to dry up should they have to be disclosed, as hedging would become much more difficult.

Impact on financial stability and innovation

53 Requiring firms to disclose their internal models could have a harmful impact on financial stability. That is because the markets most significantly affected by this requirement would be the tailored OTC derivatives and structured products markets, which have become central to the efficient transfer of risk between the cash and derivatives markets.³² Banks currently have an incentive to build sophisticated models because they hope to benefit by managing their risks better and at lower costs. Requiring significant information about models to be disclosed would mean that their proprietary value would be lost. Innovation would stop.

54 By having to disclose proprietary information, dealers would also be exposing themselves to the distorting effects of gaming, particularly by hedge fund clients, who are active in these markets, have access to full information across the various products and do not run the risk to their book that dealers face. Many hedge funds hold larger positions and have better access to information and prices than many dealers.

Impact on competitiveness of UK financial markets³³

55 The proposed disclosure regime implies that Chapter 3's objective is, at a minimum, to secure full transparency of mark-ups and perhaps even to turn dealer markets into quasi-agency markets. If an agency market were to be imposed in the UK by means of over-regulation in this way, there would be a risk that the market would move "offshore" (just as the Eurobond market originally developed in London in response to changes to tax law in the US). Driving business offshore would clearly not be consistent with the FSA's legislative principle of good regulation to maintain the international competitiveness of UK financial markets.

³² See ECB Occasion Paper (op cit.)

³³ "Financial firms based on London account for approximately 60% of the book-running of all international bond issues, as well as about 70% of secondary market trading. In addition, UK-based firms are commonly estimated to account for 80% or more of inter-professional trading." (DP 05/5. #2.9). According to the latest BIS Triennial Survey, London is also the largest global centre for booking OTC derivatives trades.

Impact on market structure and firms' business models

56 Our member firms have indicated that they use the principal dealer quote-driven model for at least 95% of their wholesale fixed-income operations. By contrast, most firms' retail operations are conducted via an agency desk that is effectively segregated from the firms' dealing arms. Introducing an intermediary agency-type model within firms' wholesale operations would not be a viable alternative for these firms. It would require firms entirely to reconfigure their business models, and would be likely to make it no longer viable for them to remain in the market. This is why it is essential that the FSA interprets "executing a client order" and "client instructions" in the way proposed in our section on scope in #4-#5 above.

57 A further significant concern is that the benchmarking proposal alone could create a dysfunctional market structure. In promoting the use of e-trading systems as a means to obtain the price information necessary for delivering and monitoring best execution, the proposal fails to recognise the importance of the voice market as an essential complement to other forms of trading, including in the price formation process.³⁴ This could also lead to a competitive distortion in the market in favour of dealing through an electronic request-for-quote (RFQ) model in an MTF, which would not be required to deliver best execution under MiFID.

Impact on investors

58 Taking account of all these factors, it is very likely that dealers would pass on to their clients the increase in their costs arising from the introduction of benchmarking, probably via a commission-based structure, as suggested in Chapter 3. As a result, the imposition of "best execution" would actually cost investors more than the current system.

59 Disclosure requirements drafted with equity markets in mind in the Market Abuse Directive have led to a reduced volume of research in fixed income markets. The benchmarking proposal – which also appears to have been drafted in places with equity markets in mind – risks further information being withdrawn from fixed income markets, to the detriment of investors, in particular those that DP 06/3 and the IBM Paper are specifically arguing will benefit (ie small institutional and retail investors).

60 Benchmarking would not directly benefit retail investors. Both smaller institutions and retail investors access the market through financial intermediaries and distribution networks. They do not go directly to dealers' trading desks.³⁵ In those circumstances, it is the responsibility of the retail broker to obtain the best possible result.³⁶

61 There would also be a risk of mis-selling if the spurious accuracy of benchmarking created a false sense of security among retail investors. Investors need to understand the market and credit risk that they take on when they make an investment in a security. A benchmark would not replace this.³⁷

³⁴ "Electronic platforms are usually described as transparent and voice communication as opaque, but which of these trading mechanisms will provide the most efficient pricing will depend on circumstances. ... A voice-brokered market can be more price efficient than an electronic market because it allows a more sophisticated response to trades that are in fact uninformative. ... Transparency of a less efficient price from an electronic setting may not be as desirable as a somewhat less transparent but more efficient price from a voice-brokered market. ... This is particularly relevant for the B2C segment of the market. A customer with a large position to trade may be better off communicating this to a single liquidity provider, sparing him both the likelihood of experiencing a winner's curse and the fear that there is an impending adverse information event." (CEPR Report cited above, pages 12-13)

³⁵ See the chain of execution model used in Chapter 2 of DP 06/3.

³⁶ "Given that the number of UK retail investors participating directly in the secondary bond markets appears to be small, it may be that the cost of providing these investors with better information is disproportionate to the benefit." (DP 05/5, #5.18)

³⁷ "One important issue is that many retail investors have very limited knowledge of the bond markets. Nevertheless, we feel that there are sufficient sources of information available to investors –

The costs and risks of the proposal far outweigh any benefits

62 In summary, the costs to the industry and market users would be unquantifiable but enormous, and the risks in terms of impact on market structure and liquidity, far outweigh any benefits that the benchmarking proposal might bring in some limited areas. It would be complex to introduce, and involve a long lead-time; there would be a lack of data in support; and it would be conceptually flawed, owing to failure to take proper account of the economics of dealer markets. The costs of introducing the scheme would ultimately be borne by clients, especially as a result of the reduction in liquidity and, to a lesser extent, greater compliance costs, without countervailing benefits in terms of market efficiency and investor protection. All of these effects would have an impact on market structure and firms' business models in a way that could impair and imperil the international competitiveness of the UK financial services industry.

(iv) Is there an alternative to benchmarking?

63 There is an alternative approach to benchmarking readily available. The alternative would be to adopt a principles-based approach based on "intelligent copy out" of the best execution provisions of MiFID, as set out in parts of Chapter 2 of DP 06/3. For example:

- " ... best execution [is] more than the achievement of best price. Price is significant – but execution quality can depend on other factors as well." (#2.1)
- "[MiFID Level 1 Article 21] does not prescribe in detail how its requirements apply to the diverse circumstances in which client orders are executed." (#2.5)
- "We suggest Article 21 does not presume that there is one right answer – the importance and significant of the factors may vary between clients and instruments. And it may be possible for there to be more than one way to execute a particular order and achieve best possible result." (#2.21)
- "MiFID recognises that while the factors it specifies are likely to be the most important in achieving best execution, it is for the firm to determine the relative importance of these and other factors." (#2.30)

64 In the same way, the FSA's framework principles should allow firms operating in dealer markets the flexibility to develop their own detailed approaches to best execution policy. Since best execution is likely to be an area where firms will seek to differentiate themselves on a competitive basis, it is important that the FSA avoids being overly prescriptive in specifying how firms should meet their best execution obligations. By contrast, Chapter 3 of DP 06/3 appears to be proposing to adopt a policy which will accept as legitimate only a very narrow, price-focused, best execution policy, regardless of client wishes.

65 MiFID Connect industry guidance on particular aspects of best execution should be used to supplement the FSA's framework principles, where market participants think it useful or necessary.

ANNEX A: THE ASSUMPTIONS IN THE IBM PAPER

Introduction

In responding to DP 06/3, we have sought members' comments on the IBM Paper which FSA commissioned. IBM concluded that a benchmarking approach to achieving best execution in dealer markets may be "feasible and attractive". That is not a view shared in dealer markets.

FSA's proposition, the practicality of which the IBM paper claims to have validated, is that "a firm could satisfy MiFID best execution requirements when it deals on own account, provided that it *discloses* to clients and *executes* transactions according to a formula that linked its price to an appropriate price benchmark".

The IBM paper makes many assumptions, none of which have been validated since IBM held no discussions with firms. This note sets out (in italics) the main assumptions and questions posed by IBM, and provides (in ordinary type) firms' comments in response.

The note divides the assumptions and questions as follows:

(i) IBM's cost benefit analysis (qualitative only and with no input from firms)

- Benchmarking using prices from B2C platforms
- Benchmarking using prices from IDB platforms
- Benchmarking using internal models

(ii) Other assumptions and questions scattered through the report

(i) Cost benefit analysis

Multi-dealer B2C platforms

Costs

1 Sell side set-up and ongoing implementing costs are likely to be reasonable - assuming that dealers will not have to store quotes-only trades.

False – the cost of setting up the benchmark systems themselves would be very high. This would require firms to build comprehensive data systems capturing and storing all available data for external referencing. In addition, see the response to Assumptions 2-6 below.

2 But the time cost of additional calculation steps in front-office pricing systems could prove to be significant – so in markets where speed of execution is a powerful advantage, dealers offering best execution could be at a disadvantage.

True – speed of execution is important in most markets. Own goals caused by calculation delays will result in complaints, which are currently very low as FSA noted in DP 05/5, and making clients good on prices they rightly deserve.

Any real-time reporting requirement arising from the pricing system is likely to place a significant additional load on the system (see Assumption 3 below). As a consequence, dealers could be expected to price less inventory (to fit more information and calculations in the available bandwidth and time constraints). This would make obtaining a level – even for mark to market purposes – far more difficult and time-consuming for customers.

The FSA proposal would lead to increased cost for dealers in order to create a system which would also potentially reduce dealer margins. Dealers will therefore need to restore profitability by passing costs back to best execution clients through increased mark-ups. The end-result is likely to be the same competitive model with an extra cost burden, resulting in worse execution for clients, and entirely owing to regulation.

3 Back office reporting systems are likely to require simple changes – therefore low set-up costs.

False – whole new streams of benchmark price data will need to be established, one for each of the tens of thousands of products each dealer could potentially trade. Taking an example, a trader would need to book the benchmark price into the trading system and the pre-agreed dealing spreads (“PADS”) would need to be applied: currently, bonds are booked at a net price - neither of these fields currently exist in front, middle office or operational systems. Net pricing is preferred in fixed income markets because it allows comparison of yield between different dealers and bonds. Confirmation and statement templates would also need to be redesigned. Overall, development and testing costs would be substantial.

IBM also makes the assumption (in both Assumptions 1 and 3) that the sell-side front office pricing systems will be doing the trade reporting, whereas in reality it is back office operational systems that perform trade reporting at this point. A front office pricing system will have access to other markets at time of execution whereas the operational systems will not, but if the trade is to be allocated post execution then the front office system will not have access to all of the settlement/clearing information for the trade. Therefore the proposal would require system changes at both front and back office, hence likely incurring significant costs.

4 The need to set up spread limits for individual bonds will be low.

False – PADS will not be a one-off static number per instrument: it will be a dynamic variable, depending on trade size and prevailing market conditions. For instance, “expected difficulties” in unwinding a position will vary across products, execution venues and market conditions. As for “differing views of risk” from dealer to dealer, this will be determined by the volatility of the product and the market as a whole in addition to balance sheet usage and time to perform role. In short, the dynamics of the market make it difficult in the extreme and very costly to set and maintain spread limits let alone pre-agree with clients.

Consequently, using the mid price as a reference price is unlikely to be an appropriate starting point – nobody deals at the mid-price and setting PADS with reference to this would not take unusual volatility and other factors into account. It would also interfere with existing client relationships to the detriment of investors by taking away the flexibility that firms currently have in providing their most valued customers with tighter spreads and greater liquidity.

5 Ongoing monitoring of reference prices will be relatively low cost because “the ECN benchmark model is not significantly different from current practice” - assuming quotes do not have to be stored and review is annual.

False – for this to work, quotes will have to be stored. Although monitoring will be made more straightforward, this will involve further resource hiring for many firms. It is unlikely that the FSA will be content with firms annually reviewing the quality of best execution when the data can be viewed immediately and action taken against trades outside of PADS.

6 Buy-side costs will increase through the need to hire staff qualified to assess dealers internal models.

True – and doubtless, this will indirectly increase costs to clients. A move to compel dealers to disclose the workings and specific model variables would likely cause withdrawal of liquidity from the market, which would also increase the buy-side cost of doing business. In addition, more red tape will make it more difficult for smaller firms to compete.

Benefits

7 Small dealers may suffer greater relative costs but enhanced transparency will enable them to attract business from the big players

False – as already explained, imposing price transparency via the benchmarking proposal is highly likely to cause a withdrawal of liquidity by dealers. This may be more pronounced amongst smaller capitalised firms and in the less liquid bonds, if for no other reason than the direct relationship between a small capital base and the inability to carry a large inventory. There is strong anecdotal evidence from the US TRACE experience that, as spreads tighten with price transparency, small firms can no longer compete because their return on capital is paltry. They cannot attract business from large firms. Indeed, regional institutions, which used to invest with regional dealers, are moving their business to the large global banks, which can afford to give better pricing. As a result, small firms are starting to drop out of the market. With spreads tightening, the only way to maintain profitability is to increase volume, and only firms with very large capital can afford to do this. Consequently, it is likely that greater transparency will drive small firms out of the market. Greater transparency should be left to market innovation and the FSA should note that spreads in European corporate bond markets are generally tighter than the US markets, even post TRACE.³⁸

8 Buy-side costs to trade should improve because of lower search costs.

False – there will be lower search costs only if liquidity is maintained. If liquidity dries up, buy-side institutions will eventually suffer because they will not be able to sell their positions quickly at a price approaching the “prevailing market price”. In addition, there would be likely to be a plethora of reference prices: an ECN-based reference price; an IDB-based price; and many internal model-based prices. Additionally, because of various variable factors, it would only be possible to negotiate a dealers’ spread on a trade-by-trade basis. Different reference prices would require a client to search the market to identify the different reference prices available, and then adjust them for the different dealer spreads to establish the overall best bid or offer price available in the market. This additional work may in fact increase the buy-side’s search costs.

The costs of the benchmarking exercise would need to be passed on somehow. The dealer would have two options: create a wider spread over the “benchmark” or withdraw liquidity. In effect, mandatory benchmarking would actually cost investors more than the current system. So the proposal would not result in “cheaper” trading for the customer.

Most buy-side institutions already have a number of dealers, price sources and B2C platforms that provide them with a great deal of price and other information. Search costs are already adequate, as noted in the recent CEPR research (May 2006). “Retail” access the market through stockbrokers or their bank. There are no barriers to these retail facing providers accessing similar execution venues.

Effects on various markets

9 Bond markets are likely to get the most net benefits because the numbers of uninformed investors are greatest here and they will benefit from reducing the current information advantage dealers possess.

False – if this assumption that there are a large number of uninformed investors relates to investors active in dealer markets, the assumption is incorrect. The request for quote model on which the dealer market structure relies allow investors to obtain trade information, including price, from several dealers, while dealers do not have such information about their competitors. The only information that a dealer may possess that an investor does not is the dealer’s client flows, which allows the dealer to offset risk. Also, even “small fund managers” are a lot more professional and informed than the FSA / IBM may give them credit for; and it should be noted that some of the best performance originates from these industry participants. Benchmarking will not assist these institutions: they already see the best prices available and naturally execute at best.

³⁸ CEPR Report: European corporate bond markets: transparency, liquidity, efficiency (May 2006)

There is indeed an asymmetry of information between dealers and retail investors. This is because the flow of information is organised around active market participants, over 95% of which are institutional. But retail investors participating in dealer markets do so through institutional intermediaries who do have access to this information.

10 Investors in other instruments (eg simple interest rate derivatives) may receive few benefits while the increased costs will depress dealer margins. Increased investor confidence due to enhanced transparency may however increase business.

First sentence: **True**.

Second sentence: **False** – it is false for IBM to suggest that increased transparency in simple interest rate derivatives markets may increase business due to increased investor confidence. Many customers who trade such derivatives, (and would, where relevant, enjoy best execution under MiFID), use these transactions for hedging purposes, or otherwise to tailor their risk profile. These clients “use” these instruments; they do not “invest” in them. Their propensity to trade is a function of their hedging requirements and risk appetite, and is not particularly dependent on price transparency. The same argument applies to OTC derivatives generally.

Overall assessment

11 A client-dealer ECN benchmark model should prove acceptable to the industry, since the efficiency of the existing market means that such a model will require the industry to make only minimal changes. So trading on a best execution basis using this model should prove attractive compared to the alternatives of interposed broker or eligible counterparty models.

False – benchmarking will not entail minimal changes, as outlined above. In addition, mandatory pre-trade transparency in electronic bond markets via the benchmarking proposal could lead to a withdrawal of liquidity provision from benchmarks, starting with smaller dealers. Naturally, this would undermine the integrity of the benchmark.

In less liquid markets, it may not be possible to obtain a quote from more than 2 or 3 dealers (the vast majority of the 110,000 bonds on the CUPID database) – on page 41 (3rd paragraph), IBM notes that any fewer than this number of dealers could lead to reduced “market efficiency”. If benchmarking made this fewer still, the likely result would be a less liquid market for the majority of bonds.

The IBM proposal is for a single model for the entire market: one size does not fit all. As noted elsewhere in this response, the interposed broker and eligible counterparty models are not the only alternatives available.

Finally, since the only part of the IBM assumption with which we agree is the existing efficiency of the market, it is not clear why changes are being proposed when the consequences of such changes would damage market efficiency without improving investor protection.

IDB platforms (screen-displayed not voice-brokered prices)

Costs and benefits

12 Likely to be very similar to the costs and benefits of a multi-dealer B2C mode.

True

Overall assessment

13 An IDB model is likely to be as acceptable to the industry as a multi-dealer B2C model except for one consideration. Firms may be reluctant to disclose IDB prices.

False – No benchmark model, B2B or B2C, is likely to be acceptable to the industry for the numerous reasons expressed throughout this response. It should be noted that sell-side firms are precluded by IDBs' terms of business from passing their price data on to third parties. However, the institutional buy-side is able to verify execution quality, as IDBs often feed their price data to sources such as Reuters.

The FSA should also note that the IDB price is not a "risk free" price, as there are often difficulties in laying off trades from the B2C into the B2B space.

In addition, the recent CEPR report on EU government bond markets concludes that mandating full price transparency in the B2B space would lead to reduced price transparency in the B2C segment, which would be detrimental to the end-investor.

14 Will buy-side requirements for best execution mean that dealers (and IDBs) are prepared to disclose IDB prices to clients given that they will be able to earn a spread over those prices?

False – see the response to Assumption 13. Access to the IDB market helps dealers offset their risk, and investors may end up with less transparency than is currently available to them in the B2C space.

Internal model prices

General points on structured products

IBM correctly recognises that most clients are sophisticated and the information asymmetry is limited for this group. However, it has not provided any empirical evidence on the number or the percentage of less sophisticated clients that the FSA is seeking to protect. Without knowing the size of this client population, it is difficult to perform a cost-benefit analysis. Moreover, MiFID Article 19 obligations on a firm to a client – fair treatment, suitability and appropriateness – should afford reasonable protection to less sophisticated clients trading in these products. With regard to retail clients, they access these products through financial intermediaries, who seek the most favourable terms from competing dealers on behalf of their clients. The vast majority of clients – regardless of sophistication – talk to two or more competing dealers when they wish to invest in structured products. A small minority engage their own structuring advisors to talk to competing dealers on their behalf. Overall, competition between dealers is the most effective means by which clients – regardless of sophistication – currently obtain the most favourable terms, which besides price, may include quality of advice and commitment to buy back or unwind.

Internal model prices are used more for structured products than for cash bonds. IBM correctly acknowledges that different firms have different models and inputs for the same product owing to differing views on risk and market direction, differing proprietary valuation methods and differing positions. Internal or external validation in this context will be of limited value and costly, as there will not be a benchmark against which to compare (See Annex B). Dealers will not wish to disclose to their clients the structure and parameters of their internal price models as these are highly valuable proprietary information. Any requirement to disclose such information will stop product innovation overnight. It is also inappropriate to disclose the internal model price and mark-up spread as sophisticated clients (eg hedge funds) may exploit such information. The suggestion that a firm may wish to run a simplified, externally verifiable "best execution" model in addition to its complex, unverifiable internal pricing model is not realistic on cost grounds, would not produce meaningful information and would also increase the risk of litigation. It is impossible to construct two different models and expect them to run in parallel under all market conditions.

While IBM has conceded the substantial costs of internal models for complex products, it has failed to identify any significant benefits to the small proportion (by its own admission) of less sophisticated clients, who at present are obtaining favourable terms by asking competing dealers to quote on a product.

Costs

15 *Cost of implementing will be minimal since it largely reflects the current pricing activities of OTC market dealers.*

False – similar cost considerations apply to internal model-based benchmarks as to IDB/ECN based benchmarks.

16 *But dealers may be reluctant to disclose details of proprietary models to customers since they are seen as a source of competitive advantage.*

True – see the response to Assumption 6 and “General points on structured products”. In addition, disclosure is irrelevant to retail investors as they are not in a position to understand the variables. Disclosure of internal models to institutional clients, and inevitably competitors, is commercially unacceptable.

17 *However, if a dealer decided to use separate models for internal pricing and best execution pricing the costs could be significant – from duplicating calculations and time costs for updating price information.*

True – we should not have a regime imposed on the industry requiring duplicate efforts in modelling.

Benefits

18 As before.

Overall assessment

19 *IBM expresses no view but FSA has stated that it has “strong reservations about whether, in using an internal benchmark a firm could adequately manage its conflicts”.*

False – well run firms already deploy “objective and unbiased” models. For products which are priced off and marked to model, there is an approval process involving senior members of front office and control department management. As such, on a cost-benefit analysis, benchmarking for these products is unlikely to prove valuable.

20 *DP 06/3 asks the following question (aimed primarily at clients): “Are there any circumstances in which an execution model which uses internal benchmarks could be sufficiently robust to satisfy the best execution requirements? If so, what?”*

True – when they are unbiased and objective - see the response to Assumption 19.

(ii) Other assumptions

21 *Quotes on Bloomberg ALLO (and similar) are normally indicative, may be out of date and, if used as market benchmarks may be ‘gamed’ by some market participants. IBM therefore does not consider them sufficiently robust.*

True – much of the pricing on ALLO (and similar) is indicative, especially in institutional size. Indicative prices are not reliably updated until a quote is requested: as such, they could be gamed – they are not robust enough.

22 *IBM assumes that IDB and ECN quotes would not be “gamed”. Is this likely to be correct?*

False – all prices are subject to dealer positioning. The IDB prices are often one way only and may reflect dealer “gaming”.

23 *Transaction data is dismissed as a reference benchmark as it is out of date.*

True – past trades cannot be used as a reliable benchmark: even liquid markets change quickly and the majority of bonds trade too infrequently for them to be afforded reference status.

24 Reference price: best bid or offer or mid-price? IBM offers no view but assumes that 1) Mid-price closely matches current practice where clients seek to minimise dealer spreads – to minimise their cost of trading. 2) Bid or offer pricing enables the client to see the incremental variance the dealer is adding to the ECN/IDB price. If benchmarking was introduced, which would your firm prefer?

As stated in the main part of our response, mid-pricing does not work, especially in volatile markets. Even in “plain vanilla” products like government bonds, different firms use different models, so “mid-market” is not necessarily the same for all dealers. A benchmark based on mid-price would therefore inevitably become artificial, since it would not reflect the prevailing market price. It is possible that this change would result in dealers adding large spreads to the mid-price level to reflect their views on risk and their position in the market. Investors would not achieve a better deal than they do now, where they poll their chosen dealers for their best level and can decide whether to trade at the best bid/offer.

Using best bid/offer has its problems too, especially for illiquid products which have fewer dealers – and may have only one – giving quotes

25 When there is disclosure of the reference price (as IBM proposes), rivalry between dealers to attract best execution business will drive dealer spreads to competitive levels.

False – the market is *already* extremely competitive. Over the past five years, dealer spreads have compressed across all asset classes, including in relatively new products such as ABS where bid-offer spreads are less than a third as wide as five years ago.³⁹ This is a sign of an efficient and competitive marketplace. CEPR’s recent study on European corporate bond markets concludes that bid-offer spreads in this market are tighter than those in the US corporate bond market, even post TRACE.⁴⁰ The FSA’s own analysis of the dataset provided by ICMA reaches the same conclusions.⁴¹

In some segments of the markets, such as the government bond market, spreads have compressed to such a level that secondary flow trading does not offer an attractive return on capital for many banks. If bid/offer spreads compress much further, banks may well reduce the amount of balance sheet available for secondary flow trading and reallocate it elsewhere.

If benchmarking were to be imposed in the UK, there is also a question about what would happen if the rest of the EU did not adopt it. In markets outside the EU (eg New York, Hong Kong, Tokyo and Zurich), the market would be likely to continue as it does today. That might lead to a two-tier market: one for firms subject to FSA rules and the other for everyone else.

26 The result will be that two clients with identical characteristics and trading in the same instruments in the same volume at the same time will be offered both the same reference price and the same dealer spread if the deals were executed on best execution terms.

Same reference price: **False** – this assumes that there is a definitive reference benchmark for each instrument. In the absence of a central body assigning each product a benchmark, firms would have to choose where to source their benchmark from: eg

³⁹ TBMA response to FSA DP 05/5, Annex 5 (Price formation process and efficiency)

⁴⁰ CEPR report: *European corporate bond markets: transparency, liquidity, efficiency* (May 2006)

⁴¹ “In new, large European bond issues, we find spreads that are narrow (averaging just 0.023% during our sample period) and that are sometimes negative. ... Our findings suggest that corporate bond spreads in Europe are noticeably tighter than those in the US. This is also supported by the evidence presented in the CEPR report on Europe’s corporate bond markets, and with the comments we have received from market participants. Tighter European spreads are observed across all trade sizes, including for smaller, ‘retail-sized’ trades.” (FS 06/4, #4.6)

eSpeed, Brokertec, MarketAxess etc. So clients would not be comparing the same benchmarks.

Same dealer spread: **False** - naturally, each dealer's pre-agreed dealing spread will depend on myriad factors. It is impossible to expect dealers to be the same even in these homogeneous circumstances.

Finally, a more valued customer is more likely to receive greater liquidity and tighter spreads notwithstanding that he may have identical characteristics to a less valued customer.

27 The pre-disclosed dealer spread will not be included in the best execution calculation (ie it will be treated like a commission) and therefore this approach is likely to meet industry interests.

False – benchmarking is unwanted, let alone the separate disclosure element.

28 At least in non-retail markets it is reasonable for the buy side to test how competitive the spread being offered is: the difficulty for the buy side at present is that, because a net, bundled, price is quoted, they cannot test either the competitiveness of the spreads or the tightness of the underlying pricing to a reference price. Under the benchmarking approach to best execution this constraint is removed.

False – the buy side already tests prices all the time, calling different dealers and using multi-dealer ECNs and checking against IDBs. Institutional client feedback to the FSA and at industry groups has been that they are content with the level of pre-trade transparency. The buy side will not be appreciative of “better” transparency if liquidity suffers as a consequence. Price competition in this form will likely not reduce spreads further as there are structural reasons why spreads are where they currently are – and that is not due to a lack of transparency.

The reference price is imputed from dealer positions, not vice versa. Prices are purely market and position driven. It is not clear what the client gains from unbundling except more bureaucracy that needs to be paid for.

29 It does not seem reasonable to require investment firms to offer the best spread in the market: it would require them, for example, if their view of risk was less favourable than the market's, to include the market view in their spread.

True – as explained in the main responses, this Annex and Annex B, there are several considerations that affect dealer spreads, with the result that a dealer may not be able to match the best spread in the market.

30 Dealers make their profits on the difference between bid and offer.

Partly true – bid/offer spreads are not pure dealer profits, but mainly an aggregate of several factors, as explained previously.

Usually, the bid/offer spread just about covers trading desk costs after hedging costs. Profits are generally made through correct market and single name positioning.

31 The costs of implementing the benchmark model will reduce dealer profits for those dealers who choose to offer best execution.

True – perhaps to a point where capital is deployed elsewhere. Liquidity will be withdrawn. And additional regulation will also mean more time and resource spent.

32 Disclosure to clients:

- *The reference price should be disclosed on a trade by trade basis, pre-trade, whether the reference price is taken from an external source or an internal model*

Theoretically true – reference prices should be disclosed at the time of execution. The disclosure as to the source type of the price is unlikely to be of any value to an institutional buy-side client, as these institutions already have satisfactory pre-trade transparency.

- *The dealer spread limits on the reference price: these should be set by prior agreement*

False – see the response to Assumption 4 for reasons why pre-agreed dealing spreads are not practical.

- *The actual spread applied for a given trade; disclosed at the time of the quote.*

Theoretically true – as pre-agreed dealing spreads are not feasible.

However, as emphasised throughout, in practical terms the whole concept of benchmarking is not appropriate to dealer markets in general.

33 Other incorrect assumptions:

The key assumption repeatedly made in the IBM paper that dealers add spread to the B2B/inter-dealer price for a liquid fixed income security before presenting to clients in the B2C market is fundamentally flawed. The number of competing dealers in the client-facing markets means that B2C markets are already tighter than B2B. (See Annex B, #7).

IBM also inappropriately assumes (page 38, 3rd paragraph) the continuance of market conditions as they stand today, and that benchmarking might not work in a “bear market”. In times of great market stress, dealers are needed the most. Removing liquidity at such times could lead to systemic risk (as in October 1998). Naturally, it should go without saying that any regime as fundamentally different from today’s market structure must be able to withstand all market conditions and trends.

Similarly, with regard to information asymmetry (page 38, footnote) – although it is agreed that retail may not have the same level of information regarding a bond as an institution, the assumption that this asymmetry makes retail less likely to trade bonds in secondary markets does not ring true. There are many reasons why retail does not tend to be active in secondary markets, including their investment objectives and preferences (e.g. the UK’s long standing equities culture), the media, government (through privatisations) and investment firms have long encouraged retail investment in equities. Most retail investors buy at issue and hold until maturity. Relatively little coverage is given to bonds, let alone via direct investment.

It should also be noted that market failure has not caused this information asymmetry nor does it explain the fact that retail tend to invest in simpler products.

ANNEX B: FUNDAMENTALS OF BOND, DERIVATIVES AND STRUCTURED PRODUCTS MARKETS⁴²

BOND MARKETS FUNDAMENTALS⁴³

1 *Bond markets are not centralised*

Equities generally trade almost exclusively on exchanges, and most of the liquidity in a particular share is found on one exchange. According to statistics from the Committee of European Securities Regulators, “in 95 % of all the cases, the most liquid [equity] market had at least five times the size of the second biggest [equity] market (using the criterion “volume” as well as the criterion “turnover”). In 90 % it had even more than eleven times the size of the next biggest [equity] market”.⁴⁴ Because of this centralisation, investors with orders that fit into the size profile of orders on the exchange will route these orders to that exchange. As a result, bid and offer quotes for a share can easily be combined and a best bid and offer determined.

In contrast, although most bonds issued into Europe are listed on a European stock exchange, only an insignificant proportion of such bonds actually trade on exchange. Most bonds trade over-the-counter in a decentralised dealer market⁴⁵.

There are a number of reasons for this. Whereas an equity investor must deal almost exclusively in the secondary market to buy and sell a share, a bond investor who is looking for yield can buy a bond and wait until redemption in order to realise his investment and thus never enter the secondary market. Also, while each share trades on the unique dynamics of a particular company’s future prospects, bonds are generally traded within groups according to their credit rating, maturity and yield. Finally, bond markets are much less concentrated than equity markets: according to FSA statistics there are 8,000 listed equities in the EU but over 200,000 bond issues in ICMA’s TRAX database.

As a result of the combination of these factors, other than for a small percentage, bonds do not trade continuously and in a centralised market as do equities. Because trading is sporadic there usually is not a natural investor when another investor wishes to buy or sell a bond. Thus, investors rely on dealers to provide liquidity where no natural contra-side exists to their trade.

A large portion of all secondary market volumes are traded by voice in both the inter-dealer and the dealer-to-customer markets.

Most of the inter-dealer (B2B) bond market is intermediated by voice brokers, with few very limited exceptions, such as a large part of the covered bond market, where dealers may quote prices to one another. Inter-dealer trading also occurs on e-trading platforms, mainly in respect of government bonds and for smaller sizes.

In the dealer to customer (B2C) space, most trading volume also occurs over the telephone or via Bloomberg messages between dealers and their clients. Many dealers have developed proprietary e-trading systems (known as single dealer systems) in which

⁴² This description focuses on European markets, although most of the principles and fundamentals are equally applicable to non-European markets.

⁴³ “In the case of the bond markets, there are a number of characteristics that differentiate bonds from equities and which we consider to be particularly relevant to any assessment of appropriate transparency” (DP 05/5, #1.15).

⁴⁴ CESR’s Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments, 27 June 2004, page 107

⁴⁵ “These differences appear to explain...why the trading methods in UK bond markets are substantially different from those in equities. Whereas the major part of ...trading in UK equities has gravitated to electronic order-book trading. So far this is not the case in UK bond markets. Dealer-provided liquidity remains a central feature of the market and the majority of bond trading in the UK remains dealer-based. This is an important factor when considering the appropriateness of transparency arrangements.” (DP 05/5, #1.16)

their clients can view the firm's inventory and enter into buy, and, sometimes, sell transactions. Further and as more fully described in paragraph 7 below, the small percentage of bonds that are liquid and trade frequently may be traded on multi-dealer B2C e-trading platforms⁴⁶.

The combination and complementary nature of electronic and voice trading in all segments of the EU bond market (albeit weighted differently depending on the sector) provides the market infrastructure for achieving efficient price formation and discovery across all such segments for institutional investors and private client intermediaries who are customers of most of the dealers on B2C platforms and have access to several dealers through voice trading⁴⁷.

2 *Because bonds do not generally trade on exchanges, there is not a class of exchange-designated market makers in bonds*

Institutional investors are well aware of the dealers that make markets in bonds in various asset classes. As mentioned above, they can be contacted by telephone, through their proprietary trading systems, or as "price makers" on e-trading platforms, meaning that they list their inventory for sale at, typically, indicative prices and, in response to a request for a quote from an authorised client, they will (but are not required to) quote a price to buy designated bonds from the customer.

In the equity market, the determination of which firms are market makers is made on a security-by-security basis. Because there are so many more bond issues than equity issues, dealers in bonds generally stand ready to buy and sell bonds in an entire sector, rather than merely those of a single issue or issuer. Even with respect to some of the more complex and structured bonds, where it is possible that only one dealer originally underwrote the bonds, it is common for multiple dealers to be willing to provide secondary market liquidity to institutional investors who have a relationship with such dealers.

This highlights an important characteristic of bond markets which is not found in equity markets, namely that bonds with similar terms are often good substitutes for each other. The shares of a chemical company, for example, are not equivalent to the shares of another chemical company, since investors buy shares to benefit from future price changes which will depend on the profitability of the specific company. Bonds issued by different companies with the same maturity, coupon, credit rating and other terms will, however, provide very similar investment returns in terms of income and likelihood of repayment at maturity - the objectives of bond investors. Unless a client insists on purchasing a specific bond, which may have a high illiquidity premium, a dealer may be able to offer a bond with almost identical investment characteristics from his inventory at a better price⁴⁸.

⁴⁶ "The predominant form of trading in UK bond markets is based around the bond dealer. Dealers trade with clients either on a purely bilateral basis or, increasingly in some market segments, via multi-dealer trading platforms. There is also significant inter-dealer trading, either directly or, more commonly, through interdealer brokers, who provide dealers with anonymity. Open order-book trading, as used in equity markets, has yet to establish a place in the UK bond markets." (DP 05/5, #2.26)

⁴⁷ "Both in Europe and in the United States, market structures have evolved – in very different ways, as within the EU itself – to give the present coexistence of electronic and OTC markets, offering different environments that seem suited to different types of transactions." (CEPR Government Bond Report, page 6)

⁴⁸ "Whereas, a corporate normally has only a single fungible class of equity...it may make multiple issues of bonds, for different time periods, for different purposes and with different characteristics. It is not uncommon for larger companies to have tens of bonds outstanding, and some financial groups may have hundreds or, in some cases, several thousand. While there are some 8,000 listed equities in the EU, ICMA's TRAX database contains more than 200,000 bond issues. This results in a very long tail of relatively small, and generally highly illiquid, issues – an important point in any transparency discussion." (DP 05/5, #2.20)

3 As a result, there is no central or dominant pool of liquidity in bond markets

As a result, and in further contrast with the equity market, there is no central or dominant pool of liquidity in bond markets, except in the most highly liquid of markets, such as certain government bonds, supra-national organisations and large investment grade corporates. Because most bonds do not trade frequently, there is never a constant source of buyers for all bonds and investors rely on the ability of dealers, individually or collectively via telephone or e-trading systems, to provide liquidity. Liquidity is thus very dynamic and much more so in fixed-income than in equity markets⁴⁹. Because most bonds do not trade frequently, it is also difficult and costly to “short” bonds (another difference with equities). Therefore, a dealer’s willingness to provide liquidity will depend on its ability and the time needed to hedge and/or offset its trade so as to enable quotation in the first place. In times of market stress, dealers are often the only parties willing to provide a quote and to hold positions until a market imbalance is righted.

4 As a further result, dealers do not generally quote executable 2-way prices

Because of the very large number of bonds outstanding and the infrequent interest in trading the vast majority of bonds⁵⁰, dealers do not continuously quote 2-way prices for bonds other than the most liquid ones. When they do quote, they may quote indicative or 1-way prices on their proprietary trading systems or on multi-dealer e-trading platforms in which they participate. They will quote a bid price to buy those bonds at the request of a client, but are unlikely to quote an offer price unless they hold the security in portfolio, since it may be difficult and costly to cover a “short”, depending on the characteristics (in particular the liquidity) of the bonds in question. Occasionally, dealers will quote 2-way executable prices, but generally not for large trades. However, even when a firm does not publicly quote 2-way prices, it will respond to a client request to quote a price at which it is willing to buy or sell bonds including up to very large sizes. The spread between the bid and offer will reflect the dealer’s view as to the risk in reversing the position taken on from the client including the cost of capital it needs to commit to make its balance sheet available to carry the position, as well as other benefits it provides to investors, including research, providing market intelligence and help with portfolio valuations.

As in equity market block trades, large sized bond trades can be at a significant discount/premium to the prices displayed for more “normal” sized trades for that issue.

5 Bond markets are mostly principal markets⁵¹

Dealers sell securities from, and buy securities into, their trading portfolios. Many such dealers provide liquidity to their clients by buying bonds from them even though they do not have and may not find an ultimate buyer to which to on-sell the bonds. Most of their

⁴⁹ “A second characteristic of the bond market is that ...the liquidity profile of many issues changes far more dramatically over time than that of most equities. This reflects the fact that although some bonds are actively traded on a regular basis, the market overall is much more of a ‘buy and hold’ market than the equity market. While most equities experience trading spikes around financial announcements and corporate events, many... also see material levels of daily trading on an ongoing basis. By contrast, many bonds trade very actively during the first few days after issue but then trade very little over the rest of their lives.” (DP 05/5, #2.21).

⁵⁰ “Not only are average trade sizes larger than equities but trading frequency is significantly lower. Even the most heavily traded issues in the gilt market seldom trade more than 200 times a day – compared with at least ten times that figure for the most liquid equities. Similarly, the ICMA data show that, on a representative day in June this year, only about six non-government bonds (from a total of over 5,000 that traded that day) experienced 200 or more trades... This reflects the different investor profile in the bond markets compared with the equity market, with fewer active investors overall and a far higher proportion of institutional investors.” (DP 05/5, # 2.25)

⁵¹ “The predominant form of trading in UK bond markets is based around the bond dealer.... Open order-book trading, as used in equity markets, has yet to establish a place in the UK bond markets. “ (FSA DP 05/5, # 2.26)

trades are therefore done on an at-risk basis; i.e. they do not have both a buy and sell order at the time they enter into a transaction.

This is the model around which most dealers in bond markets are organised. Institutional investors understand that they act for their own account and not as an agent for them. They further understand that dealing on own account is a different concept from that of order routing for the purposes of order handling and execution.

This reflects the fact that *secondary markets in debt securities generally do not involve orders*. Institutional customers rarely place orders. They ask for the price quotes of several dealers and then may decide to transact at the best price. Where trades are for a large size, the investor may wish to transact with a single dealer at a price which may be poorer than that offered by other dealers for smaller sizes. Trading immediacy for a poorer price is often accepted by an investor because the alternative would be for the market to move away from him as the first dealer tried to unwind his trade while the investor was attempting to complete the rest of his transaction.

As a result, in bond markets price is not always the most important factor. And for some bonds, the most important factor is whether it is possible to deal in the bond at all. In the corporate bond market, "certainty of execution and settlement" is often more important than price.

Whichever the scenario, when a client requests a price from a dealer, there is an expression of interest, but no offer to buy. The dealer must receive further instruction from the client to trade at the proposed price (often the dealer will go back to the client with a price and be told that the trade was "done away" with a competitor). The client has the discretion to execute or not throughout this process. In most cases he does not entrust the dealer with an order to handle his request as agent.

Some dealers very occasionally act as brokers in the bond markets. This is particularly true where the firm has a fiduciary relationship with the investor and cannot act as principal. To execute an order to buy/sell a bond on a client's behalf, a broker has to find a counterparty prepared to execute the trade. If several dealers are prepared to quote a price for the bond the broker will solicit prices from those with whom he has a business relationship. Alternatively he might employ a specialist broker ("brokers' broker") who may be able to poll a larger number of dealers but who, like the dealer, will of course charge for the service. It is right that a best execution obligation should apply to the broker. However, since - unlike equities - bonds are often sold and bought not on the basis of a specific issue or issuer, but on the basis of the generic bond terms (such as tenor, yield to maturity, credit rating and callability), servicing the client's needs to buy/sell will involve ascertaining a market for bonds having those specified characteristics, rather than ascertaining a market for a specific bond.

A similarly rare situation may occur for a large block trade where the firm acts as riskless principal, ie it does not wish to assume the risk of the position and instead may "work the order" by seeking customer interest in purchasing the bond. In these circumstances, it is also right and accepted that a best execution obligation applies to the firm.

Finally, there may be situations where a firm is acting as dealer but also providing advice or owing similar duties to customers (For example, where firms provide advice on bond investments to clients on which those clients rely, or where retail and professional investors have sought retail client protections in this regard). Here again, it is right that there is an obligation to obtain best execution when executing an order against the firm's own account.

6 *Bond markets have developed price discovery mechanisms adapted to the diversity of bond instruments*

Bond pricing can be simple or complex, depending upon the type of bond, its maturity, yield, credit rating and liquidity. At its simplest, for a bond of impeccable credit quality, it should be worth the discounted cash flow of its future principal and interest payments. However, a variety of macroeconomic factors can even affect the prices of bonds of impeccable credit quality, including (i) current debt market yields, (ii) the current outlook

for growth and inflation, (iii) potential changes in monetary policy, (iv) benchmark yield curves (for bonds priced as a spread to a benchmark curve), (v) prevailing rates in the OTC interest rate swap markets, the exchange-traded interest rate futures market and the repo market, and (vi) credit default swap curves. Different views on these economic factors may affect the decision of an institutional investor as to the current market value of a security.

Lower rated bonds, and even some on-the-run corporate and government bonds, are also subject to an “illiquidity premium” that compensates a potential holder for the perceived illiquidity of the issue, i.e. the fact that it may take more time and effort to find a buyer than for on-the-run issues.

Growth in the credit derivatives market has had an important impact on the price formation process for the cash market in bonds. It has significantly improved the ability of market participants to price – and therefore manage – credit risk.

7 E-trading platforms growth has brought efficiencies to trading in bond markets but has not altered any of the above market structure fundamentals

Since the mid-90s, a number of e-trading platforms have been developed by market participants to improve the efficient trading of bonds⁵². There are several different types of trading platforms and trading methodologies available on such platforms⁵³. Fundamentally, the various trading structures and mechanisms available mirror the existing bond market structure and are designed to facilitate existing trading relationships between bond market participants.

The extent to which trading in different fixed income asset classes occurs on e-trading platforms rather than over the telephone depends on the degree to which the securities in the asset class are commoditised, the size of the trade, the rating of the security, its liquidity as well as overall market conditions (eg volatility). Hence more platforms trade government bonds, money market instruments and investment grade corporate bonds, where volatility is lower and liquidity higher, than trade high yield, ABS and emerging markets securities, where volatility is higher and liquidity lower⁵⁴.

Because bond trading involves search for price and negotiation rather than firm orders, investors’ preferred method of trading, and therefore the method mostly made available by dealer-to-customer platforms, is the Request For Quotes model.

Important points which may not always be obvious regarding e-trading:

- Investor participants on multi-dealer B2C platforms have more trading information than dealers. Whilst most institutional users have access to several dealer prices via multi-dealer B2C platforms, the dealers that are put in competition on RFQ systems do not see each other’s quotes.
- Multi-dealer B2C platforms provide tighter bid-offer spreads and larger sizes to investors than are available between dealers in the B2B space⁵⁵. This is because of a cardinal rule in dealer markets: dealers provide liquidity to their customers, not to their competitors. The same observations can be made in respect of voice trading.

⁵² “The trend towards more automated, multilateral trading facilities has been driven by market pressures to reduce transaction costs – which it appears to achieve.” (DP 05/5, # 2.35)

⁵³ For further details, see TBMA 2005 Report *e-Commerce in the Fixed-income Markets*

⁵⁴ We estimate that approximately 45% of traded volumes in EU Government bonds, 20% in high grade corporate bonds and less than 5% in High Yield and ABS are conducted electronically.

⁵⁵ See slides and explanatory comments appended to this Annex B. They compare and contrast the prices and liquidity available for the same security (10 year German Bund) at the same time on a B2C and on a B2B platform.

- The same quoting considerations as those set-out in section 4 above apply to quotes provided via e-trading systems. Therefore most price information available from B2C platforms is not firm until subject to a request for quote.
- Trading platforms do not create liquidity. With the exception of very few inter-dealer platforms that ask participants to provide continuous quoting obligations irrespective of investor interest, it is the dealers who voluntarily provide liquidity as per client demand. Trading platforms merely (though importantly) help facilitate this process.

8 ***Secondary bond markets are overwhelmingly institutional***

In the EU, institutional investors are estimated to account for 95% of the primary bond market and probably more in secondary market volume terms⁵⁶.

It is apparent from the above description of bond markets that for most bonds there is no readily available price on which to base a robust benchmark for best execution purposes.

OTC DERIVATIVES MARKETS FUNDAMENTALS

With an OTC derivative, no instrument exists unless and until a pair of counterparties contract some form of risk transfer between them. As such, the terms of any OTC derivative are freely negotiable. In keeping with this, the instrument is not transferable.

In other words, there is no provision for a continuous “secondary” market, as there can be for certain securities. In this (limited) sense, the functioning of the “market” in OTC derivatives is akin to that for insurance, where risk is transferred contractually. These transfers do, of course, have effect over significant terms (commonly for five years, and frequently for ten years or more).

The role of OTC derivatives is to shift risk between parties in a pure form, separately from any financial instruments, which may bundle together more than one form of risk. For instance, an investment in corporate bonds can entail credit risk and interest rate risk. Each of these risks can be isolated and transferred separately using OTC derivatives.

This risk-isolating characteristic of OTC derivatives means that their applicability is universal: any party that faces financial risk will potentially have some use for derivatives.

In practice, the earliest use of OTC derivatives was in relation to corporate treasury operations (by non-financial entities) and this application has been an important constant to this day. The primary mission of such entities is typically *not* to run financial risk; they can therefore benefit from shifting such risk to others, while focusing on their core “business” risk.⁵⁷

In order to be able to shift risk, such entities must find a party willing to bear it. Financial-services firms are prepared to do so, in expectation of being able to manage the resultant risk exposures. In other words, in common with other OTC markets, a crucial role is played by the financial-services firm acting as principal. (Consistent with this, inter-dealer brokers provide value in this market by seeking out such capacity on an anonymous basis.)

⁵⁶ “It is estimated that just 1% of UK households are direct holders of UK government securities (gilts), and even fewer directly hold corporate bonds. This compares with an estimated 20-30% of households that own shares....UK indirect retail participation in the bond markets has been growing...However, the fact that retail investors have a relatively large proportion of their savings in bonds does not necessarily mean that they are also active or significant users of the secondary markets.” (DP 05/5, # 2.13 & 2.14)

⁵⁷ Strictly, OTC derivatives allow any entity to target the level of risk that they are willing to assume. For example credit derivatives can be used by a banking entity to take *on* credit risk on a given reference entity, where it believes that the contract will adequately reward it to do so.

Entities that do take on risk in this way may then hedge it in the wholesale markets (using other OTC derivatives, listed derivatives or positions in securities and other financial instruments). But they will not necessarily do so position by position. They are more likely to manage each category of risk – whether interest rate, credit or other – as an overall “book”.

Because OTC derivatives are powerful tools, their appeal has proved as popular as theory would suggest. In turn, as more financial-services firms have seen a business opportunity in offering risk-transfer services in the form of OTC derivatives, and more capital is dedicated to this activity, such services have become more accessible to a wider range of parties, including smaller corporate entities. Applications that make certain forms of derivative accessible to a wide range of investors (including retail investors) have also been developed, for instance structured notes and deposits. Each of these economically significant developments, however, ultimately depends on the entities who are prepared to commit risk capital to acting as principal.

In line with the development pattern outlined above, there has been a certain amount of standardization of the risks transferred by means of OTC derivatives. Thus, one may readily be quoted a rate for, say, a five-year fixed-floating interest rate swap in a major currency, to begin today. And one may also find a quote for a five-year swap tomorrow; and the day after that; and this time next week. But tomorrow’s contract is a new five-year contract, as are each of the subsequent contracts. It is emphatically not the same instrument as today’s, even though a similar amount of risk is being traded.

It is, of course, possible in some cases to reverse a position taken on through derivatives. However, this requires one of three actions, each of which will themselves entail some further measure of negotiation.

- *Offsetting transaction.* This is the most commonly used method of reversing a position. One of the parties engages in a separate, equal but opposite contract (often with a third party rather than with the original counterparty), and thereby neutralises the (market-risk) effect of the first contract.
- *Novation.* With the consent of the original counterparty to the transaction, a party engages a third party to step into the trade in its place.
- *Termination.* The two parties can agree to terminate the transaction.

In all three cases, the relevant parties will take into account the current value of the contract and this will reflect what one might term “neutral factors” (such as the market price of the underlying asset). For all that, though, the market remains bilateral and trading takes place by appointment. This is true, whether the products are referred to as “plain vanilla” or “exotic”, since these terms are merely relative.⁵⁸

In all this, any notion of an order, a central venue or a best price is false. The best price for a unique, bilateral contract is by definition the price at which the parties agree to transact, since no other parties can be used as substitutes for that transaction.

As discussed in more detail in the following section of this Annex, where structured products entail a combination of derivatives and bonds, exactly the same considerations apply.

Such e-trading platforms as exist in the OTC derivatives market do not fundamentally alter any of the above. Similarly to other OTC markets, they provide a means of communication between potential counterparties, but do not in any way change a bilateral contract into a standardised, freely transferable instrument. Specifically and categorically, these platforms are not exchanges.

⁵⁸ These arrangements for OTC derivatives are different from the somewhat specialised case of exchange-traded derivatives, where the terms of trading are standardised, with the specific intention that the contracts be transferable (notably, by novation to a central counterparty) and where it is expressly envisaged that there should be a continuous ‘secondary’ market. This note does not deal with the case of such ‘listed’ derivatives.

Because of the bespoke nature and complexity of OTC derivatives, it is not easy for investment firms to obtain independent prices from other sources to establish a price (as would be the case for an off-exchange transaction in equities). Information from published price sources may be of limited direct relevance even where it is available, since transaction terms are individually negotiated and the terms on which a party is willing to enter into trades may also depend on, for example, the creditworthiness of the parties and the collateralisation, netting or other credit risk mitigation techniques that are in place between them (unlike a cash market transaction in equities, where these factors will normally not be relevant). As with any principal market, the pricing of an OTC derivatives contract may also depend on the risk-profile of the financial-services firm at the point of negotiating the contract.

It is also often not easy for a firm to obtain a comparable price or valuation from another investment firm. Many OTC derivatives are by definition customised specifically for an individual client and consequently often confidential to that client; it may be difficult to maintain client confidentiality if the price of the product had to be independently verified through another investment firm to prove best execution. Also, a firm may not wish, for competitive reasons, to give another investment firm all of the components to the transaction if it is proprietary in nature, which may make it difficult to establish a comparable price. In addition, some of the parameters required to value complex products may require a judgment to be made, and the models used to calculate the price or valuation may vary between firms causing pricing anomalies, which means that prices may not be directly comparable. In any event, other firms may be reluctant to provide valuations for transactions which they will not execute.

STRUCTURED PRODUCT MARKETS FUNDAMENTALS

There are a wide variety of structured products of three main types

(i) First, *securitisation transactions* typically involve the sale of assets by an issuer to a Special Purpose Vehicle (SPV) which then issues tranches notes solely backed by those assets (or sometimes in combination with derivatives used as asset hedges). Even amongst the largest tranches of the most well-known frequent residential mortgage-backed securities (RMBS) issuers, there is a lack of comparability between tranches of transactions because the assets and the structures are different. This means that they will, in many cases, particularly for the unrated and lower-rated mezzanine tranches, fall into the illiquid end of the spectrum of fixed income products.

(ii) Secondly, there are transactions that involve the issue of a bond or other security with an 'embedded' OTC derivative – either as a *primary "structured note" new issue offering through a debt or medium term note programme*, or alternatively created by *the repackaging desk of an arranging bank or trading desk*. By virtue of the inclusion of an OTC derivative, these structured notes raise the same issues as described above with regards to such derivatives. These products are normally tailored to meet specific client objectives, which makes all the considerations associated with OTC derivatives relevant.

(iii) Thirdly, if created by trading desks, these *"structured credit" transactions* can either be in all cash, all derivative or a combination.

Even where there is a bond or other security which is to be listed on exchange, the initial transaction will normally be made with the client to purchase the security on its creation and, given the proprietary nature of the structures, it will normally be difficult to obtain information on comparable prices or valuations. There will also normally be very little after-market trading in the security and, to the extent that the firm does trade the security, it may be difficult to obtain comparable prices or valuations for similar reasons to those described above.

In these markets, it will therefore be difficult to distinguish anything which is comparable to a conventional "order" to which best execution duties would apply. The client may request a quote for or seek to negotiate a particular transaction with the firm as a principal but the firm should not be regarded as having the same duties to the client as it would

where it accepts an order for execution and has discretion as to the manner of its execution.

In summary, imposing a wide variety of multiple benchmarks (to reflect the various components, such as asset classes and tranches or embedded derivatives) would simply create more of a fiction (and more of a burden), given that it ignores any interaction between those components, as well as the uniqueness of the package.

Pricing structured products

In all types of structured product, the pricing and terms of different transactions are not comparable. The underlying assets in the categories (i) and (iii) above are typically corporate bonds, corporate credit default swaps, asset backed securities (ABS), derivatives on asset-backed securities, or a combination.

The pricing of securitisations, structured notes and structured credit transactions ranges from somewhat complex to very complex, depending on the transaction. For instance, in each securitisation or structured credit transaction, two fundamental aspects need to be evaluated on a transaction by transaction basis a) asset characteristics, and b) structure characteristics, including the use of derivatives as hedges. Each broad category involves a multi-step evaluation process. We provide below an example of this pricing process on the most simple and well-recognised of asset classes – a UK residential mortgage securitisation transaction.

Regarding *asset* analysis, prior to pricing a transaction or development of a potential benchmark, a trader would need to evaluate the following aspects:

- 1) Geographic and borrower concentration: how granular is the pool in terms of number of borrowers, and what is the risk of a particular geographic area suffering an economic downturn, as well as correlation to the credit risk of assets from different geographic areas within that pool.
- 2) Perceived quality of the asset servicer: investors will generally require a wider spread for pools serviced by less-well known or smaller servicers, and less of a concession or no concession for large well known servicers.
- 3) Credit default probability: what is the historical arrears rate, historical default rate, variability of those rates, and prospects for recovery if defaults occur. This requires an analysis of the underwriting characteristics of the underlying mortgages (loan to value ratios, debt to income multiples, debt history etc., as well as analysis of the timing of arrears, defaults and recoveries, including lags and foreclosure costs). The trader will also need to make a pricing adjustment depending on whether the pool is backed by prime or rather non-conforming assets, as well as an evaluation of any buy-to-let assets included in the pool. Pricing will also be affected by the type of mortgage itself (ie whether it is for a property purchase or a remortgaging/refinancing). Lastly, the trader will need to evaluate mortgage payment types, including fully amortising, interest-only, or reverse mortgages.
- 4) Eligibility criteria for asset substitution (for transaction with revolving features or substitution rights): if the quality of substituted assets could be worse than the initial pool, the trader will need not only to constantly obtain current pool information, but also evaluate the potential performance of those substituted assets.
- 5) Historical and projected principal repayment and prepayment rates: this will have a material impact on the weighted average life of a security. In the UK, for example, prepayment rates on prime RMBS have ranged from approximately 20 to 40% per year, and for non-conforming product, the rates typically range from 20-60% per year due to borrower's incentives to refinance at lower borrowing costs as their financial situation improves. It is unlikely that these prepayments will be constant for the life of the pool, so traders must continuously evaluate the timing of prepayments as well. Seasonality adjustments will also need to be

made, since not only do prepayment rates vary depending on the time of year (they are typically higher in the summer), but also the impact of seasonality on default rates (which are typically higher after Christmas). This also includes an assessment of pool seasoning – even if asset pools have similar projected remaining weighted average lives, they could have very different payment characteristics depending on the coupons/rates that borrowers are paying and on changes in the macroeconomic environment since the assets were originated. Higher coupon mortgages are likely to prepay faster than current-coupon mortgages, even though the projected weighted average life for two pools may be similar.

Regarding *structure* analysis, prior to pricing a transaction or development of a potential benchmark, a trader would need to evaluate the following aspects:

- 1) Cash flow allocation sequence: each transaction will have a very specific cash flow allocation/waterfall sequence for both interest and principal that complicates pricing comparisons between various transactions. In some transactions, all principal is allocated sequentially, and in other transactions on a pro-rata basis amongst tranches, and in some it may switch between the two depending on certain asset criteria.
- 2) Credit enhancement structure and usage: each transaction will require an analysis of whether reserve funds are sized appropriately given the credit characteristics, and also whether they are fully funded or short of targeted levels. This will include checking whether any drawings have been made on liquidity facilities, since investors are likely to demand a wider spread if liquidity facilities have been tapped to cover temporary shortfalls.
- 3) Credit enhancement trigger analysis: each transaction will likely have a “trigger” mechanism whereby if certain credit related performance is breached, then cash flows are allocated in a different sequence, which will affect the timing of principal payments.
- 4) Derivatives: some transactions include interest rate swaps, caps, floors and options in order to reduce potential asset/liability mismatches within the structure. The trader must evaluate the quality of the counterparties and potential mismatches, particularly given actual pool performance.
- 5) Ratings and pool performance reports: the trader must identify which rating agencies have rated which tranches of a transaction and verify whether original ratings have changed or are under review, since a rating change in one tranche may affect the pricing of the other tranches. In addition, the trader will need to check current pool performance information to see how the pool may have changed subsequent to the offering circular being initially distributed.
- 6) Size of tranches: due to the cash flow sequencing process, most subordinated tranches will be relatively small. Since the subordinated tranches will be the most credit intensive, this small size and credit intensity will generally result in relatively wide bid/offer spreads. As a rule of thumb, the smaller the size, the less liquid the tranche.
- 7) Securities price: the spread at which an RMBS trades will depend on how far away from par the current price is, since prepayment rates will materially affect spreads. For example, a bond with an above-market coupon will probably trade at a higher yield as compared to a current or below-market coupon, since investors could actually lose money by buying a security above par and if rapid repayments occurred, then they would only receive par back.
- 8) Basel I and Basel II risk weightings: for bank investors, investor appetite, and therefore yield, will be affected by the credit risk weightings. For example, under Basel II, standardised-approach banks will have a 20% of 8% risk weighting for an AAA RMBS, while an investor bank using an advanced internal ratings-based approach could have a risk weight of 7% of 8%.

The above example illustrates the complexity of developing benchmarks for the most straight-forward asset class in Europe. For other transactions, such as structured notes, structured credit transactions and CDOs, the pricing considerations are typically even more complex than illustrated above, unless the transaction is a traded index such as CDX. Only for pools with exactly the same asset and structure composition as this index will benchmarking be theoretically feasible.

ANNEX C: ANSWERS TO FSA QUESTIONS

The BMA, ICMA and ISDA, and their working group, have collaborated with LIBA in preparing answers to the FSA's questions.

Chapter 2

Q2.1: Do you agree with the above analysis which takes a flexible approach to the application of the requirements to firms in a chain of execution, depending on the nature of the activities they perform and the degree of control over the execution of client orders?

Broadly, yes. We also agree with the examples that the FSA gives under paragraph 2.15 where best execution is limited or does not apply. However, these examples need to be considerably expanded, as explained in LIBA's response in the section on *Interpretation of "orders" and "executing client orders"*.

Q2.2: Do you agree with our views on the relevance of the specific factors in Article 21?

Yes. We agree strongly with the FSA's emphasis on process (#2.16). We stress in particular #2.21's emphasis that there is no one right answer, that the importance and significance of the factors may vary between clients and instruments, and that there may be more than one way to achieve the best possible result. We also stress #2.30's emphasis that it is for the firm to determine the relative importance of the factors. The FSA's benchmarking proposals in Chapter 3 are not consistent with this interpretation.

Should the FSA think it necessary to bring forward any specific proposals on the application of best execution provisions to dealer markets, it should ensure that they are fully consistent with the approach adopted in Chapter 2.

Where a dealer and a professional client agree that the best possible result should be based on best price, they would be free to agree the details of a benchmarking and disclosure procedure which meet their objectives. The FSA should not exert pressure on either party to adopt any exclusive since method, whether the full Chapter 3 approach or any other.

Q2.3: What additional costs will the requirements to have an execution policy and execution arrangements impose on your firm?

Costs will arise from the need to formalise the policy and ensure that the firms' systems (including IT systems) reflect it. The scale of additional costs will depend very much on how the FSA interprets and applies the new requirements. In many ways Article 21 reflects processes that firms already use, either to provide best execution under existing rules, or under existing practices to provide clients with the best possible results in order to compete for business in what are very competitive markets. The FSA should design the rules implementing Article 21 to accommodate those existing arrangements and minimise the extent of change required by enabling firms to take account of the flexibility that Article 21 provides. Our concerns about the benchmarking proposal stem from the fact that it departs from such an approach in a way that would be very costly not only to firms but to market users as well.

Q2.4: Do you agree that price and cost are the most important factors for retail clients?

In general they are likely to be. However, as specified in MiFID Level 2 Recital 67, other factors may also be relevant, and in some circumstances may be more important, particularly, for example, in the case of less liquid securities where certainty of execution and settlement may be more important, or where a retail client's need to liquidate a position quickly means that speed is more important than other factors.

Q2.5: What information will be appropriate in order to enable clients to be sufficiently informed about the execution arrangements of the firm and how will this differ as between retail and professional clients?

The FSA should adopt a copy-out approach. It is important not to overload retail clients with information about the firm's execution policy. It should be enough for retail clients to know what factors the firm takes into account, and summary information about the types of venue it uses, including the prescribed information about venues on which it places significant reliance. There is no need to prescribe any more detail than is set out in Level 1 Article 21.3 as regards professional clients, who have the expertise to seek any further information that they need without the need for regulation.

Q2.6: Are there any best execution issues unique to UCITS management companies?

No comment.

Chapter 3

Q3.1: Do you agree that under MiFID there may be demand from retail and professional clients for best execution in relation to financial instruments typically available from dealers? If so, how significant is this likely to be?

Most activity in dealer markets will occur in circumstances where firms are not "executing client orders". Where dealers are "executing client orders" on behalf of retail clients, the level of demand will probably be unchanged from where it stands today. As regards orders executed on behalf of professional clients, it would be wrong to assume that those clients are not already receiving good and efficient execution for their orders. The application of best execution to professional clients is effectively a regulatory formalisation of an existing process. However, a vital element of enabling firms to continue to provide that quality of execution is to continue to allow the client to designate how it wants its order to be executed. Without sufficient flexibility for firms to follow client instructions, the imposition of restrictive best execution obligations is likely to make regulatory "best execution" less attractive to professional clients. The FSA should therefore not try to prejudge the decisions firms may take as regards the factors that will be important to them, of which price will merely be one. Many professional clients who will fall automatically into the category of eligible counterparty may be content to accept that status and achieve the "best possible result" for their underlying clients from their own resources, as is the case today with those clients who have "opted out". Professional clients who do not fall automatically into eligible counterparty status may choose it for the same reason. Even if they remain as professionals, they may wish to achieve the same effect by providing specific instructions.

Q3.2: Do you consider that the benchmark execution model may provide a useful additional approach by which dealers may be able to satisfy the best execution requirements? If so, in what markets will it be of most use?

No. As more fully described in our response and Annex A, the benchmark execution model is unnecessary, unworkable in most parts of the dealer markets, potentially damaging to market structure and firms' business models and the competitiveness of UK financial markets more generally. The costs and risks of implementing it would far outweigh any benefits.

Q3.3: What would be the likely costs of this approach?

Unnecessarily high. In the limited areas in which it would theoretically be feasible at all, it would be very expensive to implement in practice. (See our response and Annex A). Some have suggested that the cost of implementation would exceed all other MiFID implementation costs put together, as a result of its potential impact on market structure and firms' existing business models. The diversion of effort would be an enormous and unnecessary opportunity cost. The resulting uncertainty is also deeply damaging to the efficiency of firms' preparation for MiFID implementation.

Q3.4: What particular characteristics of reference prices make them suitable benchmarks for particular instruments or in particular circumstances?

This would only be the case where the reference shows firm prices in the necessary size on which the dealer can trade directly (see #26-27 and #46-47 of our response) In other

circumstances, they are unsuitable because the reference prices serve an unrelated purpose. However, even in these circumstances, other features of the benchmark model could distort the reference prices, for example, if rigid price-based best execution requirements led to a withdrawal of liquidity from the market, the quality of market prices could suffer because of the decline in activity by natural investors. Reference prices might also be unsuitable because they show firm and non-firm prices with no indication of which are firm and which are not, so that a benchmark could not be derived from them. The FSA should resist proposals which would provide only a spurious impression of accuracy.

Q3.5: Do you agree that a dealer could construct prices by extrapolating from indirectly referable benchmark prices and thereby satisfy MiFID's best execution? Please give examples for specific examples for specific financial instruments.

No. See our response and Annex A, as well as Annex B for the factors relevant to price formation across dealer markets. The premise, that best execution is measurable solely by price, is not correct.

Q3.6: In what circumstances could financial or economic indicators or indices be relevant benchmarks?

Several financial/economic indicator, indices and other relevant macro-economic factors and sources of price information are used by market participants to inform them about the price of different instruments, and inform their views on particular sectors. These are all *relevant factors*. However, we cannot think of any circumstances or examples in which they are or could be used as *relevant benchmarks*, for the reasons set out in our response. (See also our response to Q3.9.)

Q3.7: Would dealers consider charging clients an additional fee or commission for providing best execution?

They would almost certainly need to do so, if the benchmark approach were imposed, since the flexibility and competition regarding non-price execution quality factors, which currently characterises the market and which is reflected in dealers' spreads, would have to be squeezed into the firms' commission. But it would be counter-intuitive to construct a model where firms were constrained on price-making ability by imposing benchmarks, but could add extra commission for providing best execution. It is best to leave the current market model as it is, to avoid restricting and stultifying the market, to the disadvantage of those clients to whom best execution obligations applied.

It is important to bear in mind that commissions are typically charged where a firm intermediates between natural investors, whereas a dealer is remunerated in a more nimble and flexible way, taking account of the uncertainties and risks involved in the dealer's role, through spreads. Prices in the fixed-income market are "net" because this allows the investor to compare yields across competing products. Forcing dealers to adopt a commission-based model of remuneration would reduce flexibility, increase volatility, increase costs and diminish the quality of execution, integrity of markets and investor protection. It could give rise to a situation where clients would be forced to issue specific instructions to enable the firm to obtain a better result than by following the execution policy which regulation had imposed on it.

It would be unacceptable in terms of better regulation, for the reasons set out in our response, to use the implementation of MiFID provisions on best execution to propose a fundamental restructuring of dealer markets, where the proposals are not within the requirements of MiFID.

Q3.8: Are there any circumstances in which an execution model which uses internal benchmarks could be sufficiently robust to satisfy the best execution requirements? If so, what?

This question assumes that it is possible to determine an "objective" price for illiquid instruments. The reality is that this is not possible, and that there is bound to be a level of subjectivity. If the firm disagreed with the imposed "objective" standard, it would not be prepared to take on risk, and would not deal on that basis, thereby withdrawing liquidity

and creating wider spreads for any market participants that remained (see Annexes A and B)

Internal modelling will be relevant to the firm's judgment of the price at which it deals, though several other factors will also provide the basis by which a dealer delivers "the best possible result".

We disagree with the premise of this question that a "robust" benchmark (as defined in DP 06/3) is needed to measure the price dimension of best execution in dealer markets.

We also disagree with the imputation that internal models do not enable dealers to provide good quality execution. Firms remain subject to FSA Principles.

Q3.9: What are your views on the possible benchmarks identified in paragraph 3.43? Are there other potentially available benchmarks?

As regards IDB and/or ECN benchmarks, we believe that there are no robust benchmarks that can be established in most dealer markets for the purposes of providing clients with best execution, as more fully set out in our response and Annex A.

BBA LIBOR can be useful as a factor in pricing certain transactions (as an indicator of the financing cost), but there are many other elements which determine the price of the product as a whole. Fundamentally, it is not used for execution measurement purposes. Consequently, as the BBA says in its response to DP 06/3: "Knowing what BBA LIBOR is on a particular day is valuable to know the precise amount of interest which has to be paid but it is not particularly useful in telling whether the counterparty to the instrument has obtained a good, or a bad, deal."

In terms of indices such as the IIC iBoxx and iTraxx indices, similar considerations apply. iBoxx is an index that computes indicative bid and ask quotes from 10 dealers on the most liquid plain vanilla investment grade bonds. This index is very useful for investors to use to negotiate relevant trades or value their portfolio. However, the computed price is not necessarily a reflection of the price of a particular bond in the index. Several bonds are excluded as outliers from the computed average. This index is therefore a reliable indicator in terms of sectors and categories of bonds with similar features, but not necessarily in terms of each individual bond comprising the index.⁵⁹

These pricing reference tools have developed over time and in response to industry, not regulatory, demand. Imposing them or others for use as rigid best execution measurement tools would distort them and diminish their usefulness for market users.

Q3.10: Would trade associations be willing to develop such benchmarks for the purposes of best execution? If so for what products/instruments?

No, because of the fundamental flaws we have described. If the FSA were to impose – contrary to its own principles-based regulation and to MiFID – a rigid, single option, best price rule for best execution, as responsible bodies, some trade associations or SROs would need to consider how best to meet the needs of their members and how best to mitigate the damage to dealer markets such an approach would cause.

Q3.11: Do you agree that the benchmark execution model can work for financial spread bets and CFDs?

We leave answering this question to the experts in the markets concerned. But whatever conclusion they reach, it is not possible to extrapolate from spread bets into the wholesale markets.

Chapter 4

⁵⁹ "Because the IIC bond prices are reliable, they can be used by investors as a benchmark when *negotiating* (our italics) trades with dealers, or to value their portfolios." (CEPR European Corporate Bond Report, page 31).

Q4.1: Do you agree with our analysis of the requirements to review and monitor?

While in general, the FSA's approach seems sensible, except in respect of dealer markets (see our response to Q4.5). It is important that the FSA's interpretation of how firms approach the review and monitoring of execution quality does not become too prescriptive, so that firms are not forced to devote excessive costs and time to complex methodologies which do not add value. This is particularly important in fixed-income and derivatives markets because of their decentralised market structure, making monitoring much more intensive. The FSA should adopt a copy-out approach in this area, and not impose additional requirements or expectations. We agree with the FSA's statement in #4.14 that MiFID leaves decisions about the choice of methodology to firms: the FSA should follow this approach, and not prescribe a process as set out for example in #4.12. We also agree with the FSA's statement in #4.8 that the materiality of any change in execution arrangements must be a matter for judgment by the firm.

Q4.2: On monitoring: do you agree with the comparisons suggested in paragraph 4.11? If not, how would you assess the effectiveness of your arrangements? Will firms monitor their trading on a daily, weekly or monthly basis?

The approach set out in #4.11 to test "whether the firm is actually obtaining the best possible result for its clients, and if not, why not" risks an over-prescriptive and over-mechanistic approach to monitoring and reviewing execution policy. Our member firms typically execute tens of thousands of trades per day, of many different types. It may be possible for firms to identify outliers in price against what was available in the market concerned and other alternative markets, and investigate the reasons. But as a general means of assessment, the approach is not necessarily feasible, especially bearing mind the economic difference between (1) exchanges and other platforms that provide interaction between natural buyers and sellers, and (2) dealers that have no market view, are not natural buyers and sellers, and simply provide liquidity, and the fact that trades may be of many different types to which different criteria apply. Furthermore, the approach would be unworkable where there is only one execution venue for an instrument, or where the firm is acting as the execution venue.

The FSA should not be prescriptive in this area, but should accept that there are a number of ways in which a firm could monitor whether best possible result was achieved. While price-based reports will have a role in many cases – but with flexibility over sources of comparable prices for different markets and instruments – other factors will be important to monitoring execution quality (eg valuation reports, settlement and confirmation reports, size of trades). It should be left to firms to determine what are the most appropriate comparisons, what thresholds apply, and how often they make them.

Q4.3: On reviewing: do you conduct qualitative or quantitative reviews of brokers, regulated markets or MTFs now? If so, how frequently?

Our members typically undertake both qualitative and quantitative reviews on a regular basis.

In terms of the dealer-to-customer segment in dealer markets, most dealers support one or more of the five leading ECNs for fixed income products (Bloomberg, TradeWeb, MarketAxess, BondVision and Reuters).

One of the key factors in their qualitative review or decision to support new ECNs is the capability for the platform to provide and prove "best execution" (meaning in this specific context the ability for the platform to provide an audit trail to the investor showing the price at which the investor executed from amongst the number of quotes received by him from several dealers put in competition via an RFQ facility). Supporting electronic platforms is an expensive and time-consuming exercise for firms, and it is extremely important to manage the client relationship in that process. Consequently, dealers would not support platforms which did not fully respond to their client expectations or would not survive market conditions in the long term.

From a quantitative perspective, dealers review their participation in different ECNs based on the MIS activity report that they receive from each platform, coupled with their own

internal analysis. In this review, dealers look at client and product activity as well as their performance on the platform. In addition, they review their electronic portfolio of ECNs' participation by comparing incurred connection costs versus executed client activity.

It is important to emphasise, however, that the review process is two-way. Most (fixed-income) investors also review their execution venues (including dealers) on a regular basis. They review more than just price. Some examples of other important criteria are sales coverage service, research trade ideas, access to trading for additional flow information, e-Business service, operational service (eg number of failed trades or missing confirmations). The operational aspect is becoming more and more important as a result of increased electronic trading and investor requirements for integration of the pre-trade, trade and post-trade processes ("straight-through processing") via linkages between trading platforms systems and investors' internal Order Management Systems.

The review process also takes account of relevant material changes. For example, the regulator in Belgium recently allowed asset managers in Belgium to trade CDS. Asset managers interested in these products have naturally reviewed their broker list and contracted the major CDS players in the market in order to extent the range of traded products.

Q4.4: Please estimate and explain any incremental costs that you will incur to comply with these requirements?

It is always difficult to estimate costs without knowing exactly what the rules are going to be. Incremental costs will depend on the availability of data, the charges for access to it, and additional costs of capturing and storing data. They would also depend crucially on the type of rules that were imposed. Prescriptive rules would cause costs to rise exponentially.

It is impossible to provide any meaningful estimate of additional monitoring costs caused by any benchmarking proposal until the FSA provides more clarity on the scope of the proposal (see #4 and #5 of our response) so that the impact on market structure and firms' business models may be better assessed. But the magnitude of incremental costs is likely to be large.

Assuming FSA's clarification on scope agrees with ours, there would still be important implementation and review costs in the limited areas where benchmarking may be imposed, depending on the availability of data, the charges for access to it, and additional costs of capturing and storing data.

Q4.5: Do you agree with our analysis of how the requirements to review and monitor might apply in dealer markets? In particular, will dealers be able to compare and evaluate benchmarks?

No. Since it is not possible to construct robust benchmarks in most dealer markets, there is no robust benchmark against which to monitor prices. As mentioned in response to Q4.3, dealers already monitor on an on-going basis their execution arrangements with a view to providing the best possible result to their client.

The FSA's analysis on pages 34 and 35 of DP 06/3 regarding proposed review and monitoring of benchmark prices is a natural consequence from the incorrect starting assumption behind the benchmarking proposal: ie that there is such a thing as a constant "real" price obtainable from a predominant liquidity pool.

In dealer markets, the FSA's analysis would require each dealer to review each of its competitors, since each of them is a liquidity pool.

Several references are made to the BMA's e-commerce annual survey of e-trading in fixed income markets. This survey has been welcomed by market participants on all sides as a useful source of information, and shows the variety of models and trading mechanisms that have developed to bring transparency and efficiencies to the diverse fixed-income markets. It needs to be read in the context of the description of bond markets

fundamentals in Annex B. There follows a brief list of points that clarify possible misinterpretation by the FSA about the results of the survey:

- A large proportion of the trading platforms included in the survey (and therefore of the respondents) are single dealer platforms.
- Most of the volumes traded in fixed-income markets are traded by voice (including in the so-called most liquid markets, eg government bonds).
- Most of the price information made available is of an indicative nature.
- Executable quotes are not necessarily available for both bids and asks, tend to be in respect of smaller sizes in the more liquid instruments and do not mean that a dealer may not need to refresh his price when asked for a quote.
- The growth of e-trading across a more diverse range of products is a welcome market-led development driven by investor demand. However, the FSA would be misled to think that these markets have become electronic. We refer to page 13 of the BMA's March 2006 Electronic Trading Survey previously sent to the FSA showing the average estimated percentage of EU fixed-income volumes and tickets traded OTC versus Multi-dealer B2C.

Q4.6: Have you considered what data you will need to review and monitor?

Firms would need to capture information relating to the relevant dimensions of assessing venues' ability to deliver best execution on a consistent basis, including, for example, where relevant, prices, charges, speed and certainty of execution, settlement services, search costs and development costs.

With specific respect to dealer markets, it is difficult to respond to this question without clarity on scope. It is also difficult to work out what data might be relevant for the purposes of monitoring something that cannot be constructed.

Q4.7: Have you considered any changes that may be needed to order management systems to capture data for monitoring?

The costs of data capture would be significant, and require major changes to systems and data storage. Firms would be required to build comprehensive data systems capturing all available data for external referencing, including – in dealer markets – data from trading platforms or voice brokers with whom dealers have no relationship and data from competitors which they will not be provided with. In order to avoid excessive additional cost it is thus especially important to leave it to firms to determine the most appropriate methods and comparisons (see answers to Q4.1 and Q4.2 above).

Q4.8: Will execution venues provide data to firms to demonstrate their execution quality and compete for order flow?

Yes and no. IDBs and ECNs already make data available to their users for a variety of purposes. Dealers who are also execution venues will obviously not make data available to competing dealers, but will make data available to clients (including clients who are eligible counterparties). But for execution venues to provide data, there must be a consistent pool of liquidity against which to measure execution quality. Where the characteristics of the instrument or dealers' view of them changes over time, it is not possible to provide data which are consistently useful.

However, it is important to take account of the availability, meaningfulness and cost of the data provided, and the implications for firms' record-keeping burden.

Q4.9: What other approaches do you suggest to demonstrate that client orders have been executed in accordance with a firm's policy?

In a situation in which firms execute client orders, we agree with the examples of possible alternative approaches put forward in LIBA's response to DP 06/3.

Q4.10: Is there a role for an industry-led initiative to address these issues?

The industry is constantly addressing these issues, and has an important role in helping prepare for the Commission's November 2008 review under Level 2 Directive Recital 76. It is important for regulators to have a thorough understanding of how markets work, and of possible pitfalls in what they might propose.