

EPDA Briefing Note

Quoting Obligations, Market Conditions and Multiple Trading Platforms Recommendations

Final

November 2007

Introduction

Following on from recent announcements at the EPDA Government Bond Summit in Brussels, Belgium on 25 October, as well as subsequent developments in bilateral and multilateral discussions, the EPDA would like to clarify and expand on its positions vis-à-vis 1. Quoting Obligations and Market Conditions and 2. Quoting within a Multiple Trading Platform Environment ("MTPE").

This note summarizes the collective views of the EPDA membership on the above issues to help inform their consideration by the DMO community.

1. Quoting Obligations and Market Conditions

1.1. Normal Market Conditions

First, we would like to reiterate our observations from the email we distributed in advance of the conference call on the 26 September between DMOs and EPDA members with respect to quoting in the current markets as we believe this is still relevant.

We make the observation that for a prolonged period market conditions have been marked by low volatility. This has led in our opinion to unrealistically tight spreads for quoting obligations in the existing market conditions, in particular on "off the run bonds" and long dated paper. Now that we are in a period of greater volatility and with a general repricing of risk across the markets, the **normal maximum spreads on these bonds may need to be widened or at least rethought**. However, we generally see this as a natural development and in our opinion, maximum bid/offer spreads do not equal average bid/offer spreads. If spreads are set realistically, market makers will be able to quote inside of them which will lead to a situation whereby dealers will be willing provide liquidity to each other on their own terms, rather than simply being obligated. This would be healthy for the market, and indeed reduce the need for the market conditions to be deemed to be "extraordinary", "exceptional" or "difficult".

For these reasons, we believe that spreads should be in general widened significantly to be consistent with the levels of natural liquidity in the market. This way normal market conditions will generally prevail and market makers will be able to compete within the spreads on the vast majority of trading days. This would be more reflective of a natural healthy market and minimise market distortions that can be caused by enforced liquidity. The EPDA would be more than willing to participate in any discussions on the widening of spreads within market committees or other appropriate bodies.

1.2. "Difficult" Market Conditions

We believe¹ that it is in the markets interest that during **volatile or difficult market conditions** there is a need to **ensure** as much as possible that there are **prices on the screens and liquidity in the market**.

For this reason, **we support the proposals for continued quoting for a set minimum period of time on all bonds allocated during these periods**.

In order for the EPDA to offer guidance and increase transparency to the market quickly and provide some objectively during such periods, we are proposing the establishment of a

¹ As per our correspondence with the European DMOs and the EPDA Board on 26 September 2007.

mechanism that "polls" the market on their views concerning market conditions (which in part is based on the US SIFMA's emergency calendar committee).

1.2.1. Committee's Membership and Starting Poll Process

- Any EPDA Member (whether executive or normal; investment bank representative or alternate) can call for a poll on current market conditions to decide whether it identifies normal market conditions or difficult market conditions either on all the European Government Bond Markets or a sub-set of the European Market or only a specific market²;
- The EPDA would poll the PDs via email in a specially designed (and tested) message format for such purposes

1.2.2. Committee's Voting Rules

- All eligible voters would have 15 minutes to vote on whether the current conditions are either normal or difficult;
- Quorum would be reached with 50% of eligible votes;
- Anonymous votes;
- Results to be announced along with the number of votes cast (including % of those eligible); number and % of votes estimating normal conditions and difficult conditions

1.2.3. Committee Validity of Guidance

- Decision on the guidance offered is made upon a simple majority;
- Guidance will be valid for only that trading day the vote took place or until further specified;
- Guidance can be rescinded on that trading day by the same procedure in reverse (*i.e.* a member can call for a vote that normal conditions have resumed, or that difficult conditions now apply assuming that normal conditions were selected earlier in the day)

After all reasonable efforts are made to consult with appropriate regulators, guidance will be accompanied by necessary caveats to ensure it cannot be misinterpreted in the market as it could fuel panic or increase volatility.

ACTION POINTS:

The EPDA anticipates establishing such a procedure at its Board meeting on the 5 December 2007. We respectfully request that any comments/feedback on the above procedure be received by the 28 November in order that they can be taken into account in the final procedure.

² For more information please see our note entitled "Guidance on Quoting in Difficult Market Conditions: Creation of an Emergency Markets Committee" which will be published soon.

2. Quoting on Multiple Trading Platforms

2.1. Quoting Obligations and Multiple Platforms

In the EPDA opinion, there are a few outstanding issues that need to be addressed by moving from a system that designates one platform to a Multi-Platform Trading Environment (“MTPE”) for quoting obligations:

2.1.1. Minimum Regulatory Regime

We believe that for a platform to be eligible, it needs to be either an MTF or Regulated Market under MiFID. As the MiFID regime was designed with retail investors in mind, we strongly believe that this would provide adequate protection for wholesale market participants³.

2.1.2. Splitting Liquidity

We believe that provided a Primary Dealer who makes a market on one eligible platform has rights of access to all other eligible platforms for no additional membership costs, such dealer will be able to aggregate all prices from the various sources onto the screens of their trading desk thereby avoiding splitting liquidity. In addition, platforms should be allowed to discriminate in setting trading fees for ‘aggressor’ and ‘aggressee’ provided the discrimination is not based upon the status, market maker and market taker, of the participant in order to avoid indirect barriers being created to market takers.

2.2. Accessing Liquidity

The EPDA believes that participants accessing markets even if spread across Multiple Trading Platforms should be on a level playing field. As noted in the EPDA document entitled “Third Party Access Discussion Paper, 27 February 2007”⁴, third party participation may undermine the current market structure which has found a balance among mandatory quoting obligations, liquidity provision, and a Primary Dealer’s overall relationship with a particular Debt Management Office. In our opinion, only the Primary Dealers should be permitted onto markets offered by trading platforms where enforced market making persists as they are all subject to the same constraints vis-à-vis the DMOs which makes for a level playing field. To allow access to other participants may harm rather than help liquidity in such environments⁵.

The platforms should make the list of their participants available to all participants and notify them of any (proposed) change to this list (addition and/or withdrawal).

2.3. Price Transparency

All eligible platforms are obligated under MiFID to make the anonymised bid/offer and market depth available at commercially reasonable prices to the market. Investors who wish to purchase the feed will then have a choice of provider, although we anticipate the price feeds to be of similar quality due to the sophisticated pricing engines of the dealers. This being said, we suspect that as today, most investors will get their indicative prices from the B2C platforms and negotiate their trades through the RFQ functionality thereon or alternatively over the phone with reference to these prices or those from data vendors. For these reasons, the EPDA does not believe that is

³ For the reasons outlined in the EPDA Briefing Note entitled “Regulatory Regime and Minimum Standards in a Multiple Trading Platform Environment, 12 September 2007”, copies available on request to Mark Austen on mausten@sifma.org.

⁴ Also available on request to the EPDA.

⁵ For more information, please also see the EPDA Third Party Access Paper on 27 February 2007.

necessary to create one consolidated feed for the market although we stand ready to do so if required by the DMOs.

2.4. Quoting Obligations and Monitoring

The EPDA believes that **quoting obligations and bond allocations** should be **agreed between the DMO and its Primary Dealers within its market committee or alternative designated body** by the applicable DMO such as a trade association (with the eligible trading platforms engaged only as observers). As with the Harmonised Reporting Format agreed between the EPDA and the Thomsen Committee for dealers to report their monthly volumes, we believe that an agreed format for reporting monitoring obligations should be agreed that each platform can provide to the DMO with necessary market statistics to appraise the performance of its Primary Dealers and to monitor compliance with their market making commitment. The format should be designed in a manner which would allow DMOs to easily combine a number of reports in order to assess the Primary Dealers' performance.

The EPDA retained a technical consultant⁶ to study the various technically feasible options for delivering/aggregating an agreed format for reporting from multiple trading platforms. They have produced a report⁷ which has already been shared with the DMOs' community. It is our belief that whatever system is selected by DMOs for delivering/aggregating the agreed format for reporting and the agreed format for reporting itself should only require the platform to report on a factual basis and not require it to decide or judge a primary dealer's compliance with its quoting obligations set by a DMO market committee (or other appointed body). Market making and compliance thereof is a matter between the DMOs and the PDs solely as part of the latter's agreement to provide liquidity on the former's bonds within the secondary market.

ACTION POINTS:

The EPDA will provide recommendations to the market on the harmonized format for reporting to DMOs after its meeting on 5 December **AND** the preferred system to deliver/aggregate those reports for DMO compliance checking. It is anticipated that draft recommendations on the harmonized format for reporting only will be available for market consultation prior to the 5 December.

2.5. Minimum Number of Market Makers

The EPDA is open to the idea that a platform's eligibility be further dependent on the appointment of a minimum number of market makers. Providing this requirement is not too onerous, it would allow for a competition whilst preventing fragmentation across numerous platforms which may entail unnecessary additional connection costs to the dealer community.

2.6. Market Supervision

As for market supervision, MTFs and Regulated Markets are equally required to monitor and report any abuses to their competent authority and for these reasons we do not believe there is a need to have additional safeguards in place.

⁶ E-Trading Software, <http://www.etradingsoftware.com/>

⁷ Please see "Quoting and Multiple Trading Platforms - Technical Options, 23 October 2007", produced by eTrading Software. Copies available upon request to the EPDA.

2.7. Technical Requirements

It has been suggested that there may be a need for additional technical requirements beyond the distinction of MTF or Regulated Market under MiFID. In this context, requirements such as quality and security of the technical system and disaster recovery have been mentioned.

We have addressed this suggestion⁸ and do not deem it necessary to duplicate that analysis here.

Our conclusions are that the MiFID and MTF regulations (as designed for retail) are more than sufficiently rigorous to satisfy the requirements of a B-2-B professional Government Bond Market which only permits entry to large sophisticated well-capitalised Primary Dealers. Primary dealers also have the opportunity to switch providers immediately if technical problems arise/persist and this indeed lowers the systemic risk of a single platform environment. Technical features of an eligible platform may also be viewed as being a competitive advantage for that platform rather than as an eligibility requirement beyond what is required by MiFID.

ACTION POINTS:

At the request of both Primary Dealers and Trading Platforms, the EPDA will provide, after its meeting of 5 December, recommendations on Technical/Governance/Clearing and Settlement for Trading Platforms. It is anticipated that draft recommendations will be available for market consultation prior to the 5 December. The purpose of the recommendations is to provide guidance to trading platforms for their development purposes as well as help Primary Dealers in making their platform selection.

2.8. Governance Requirements

It has been suggested that there may be a need for additional governance requirements beyond the minimum standards set for MTFs or Regulated Markets. Again, we have addressed this suggestion⁹ and do not deem it necessary to duplicate that analysis here.

MiFID and MTF regulations cover governance requirements more than adequately and the EPDA also assumes that in a multi-platform environment (as outlined above), the domestic market committees (or the appropriate designated body) will share most of the burden of governing the structure of the market by setting the quoting obligations (quoting hours, bond allocations, etc.). In the new model, eligible trading platforms would only act as a means of satisfying those obligations. Therefore, the potential for conflicts of interest between the users and owners of trading platforms is minimised as compared to the current model; and where they remain, they should be dealt with by the MTF and Regulated Market provisions of Member States in any event.

For the above reasons the EPDA doesn't consider additional governance requirements to be necessary. However, to address any residual concerns that stakeholders may have, we propose to produce recommendations on governance¹⁰.

⁸ Please see our publication entitled "Regulatory Regime and Minimum Standards in a Multiple Trading Platform Environment" from 12 September 2007. Copies are available upon request to the EPDA.

⁹ Please see the EPDA Briefing Note entitled "Regulatory Regime and Minimum Standards in a Multiple Trading Platform Environment, 12 September 2007" for more information. Copies available upon request to the EPDA.

¹⁰ Please see the Action Point under item 2.7. Technical Requirements for more information.