FIXED INCOME MARKET REGULATORY UPDATE

February 2017

Staying informed on recent policy and regulatory developments shaping credit markets in Canada & abroad

Canada

Uncleared SWAP Margin Requirements

The legal and operational challenges for the industry to implement new requirements beginning March 1, 2017 with respect to the mandatory exchange of variation margin for non-centrally cleared derivatives has forced regulators in Canada and abroad to provide transitional measures. The challenges to the industry stem largely from the volume of new or amended support documentation required to be executed with counterparties.

On February 24, 2017 OSFI announced that relief will be provided to affected Federally Regulated Financial Institutions (FRFIs). Specifically, FRFIs transacting with counterparties that do not present a significant exposure to them now have up to September 1, 2017 to meet the variation margin requirements. For all counterparties to which an affected FRFI has a significant exposure, OSFI expects them to meet the requirements by March 1, 2017.

OSFI's announcement follows that of the U.S. Federal Reserve Board and Office of the Comptroller of the Currency that issued guidance for entities covered by the rule to prioritize their compliance efforts according to the size and risk of their counterparties. The U.S. Commodity Futures Trading Commission (CFTC) also issued a time-limited no-action letter stating that, from March 1, 2017 to September 1, 2017, the CFTC will not recommend enforcement action against a swap dealer for failure to comply with the variation margin requirements. In Europe, a statement issued by the European Supervisory Authorities outlines its expectations for competent authorities (CAs) to generally apply their risk-based supervisory powers in their day-to-day enforcement of applicable legislation, taking into account the size of the exposure to the counterparty as well as its default risk.

The actions described above underline two key accomplishments of the regulatory community: 1) transitional relief from regulatory requirements to avoid market disruption; and 2) coordinated and harmonized action to ensure equivalent treatment and avoid regulatory arbitrage. The situation the industry and regulators were confronted with also serves as a reminder of the importance of not losing sight of operational and practical implementation considerations during the rule-making process.

United States

U.S. Review of Financial Regulatory Framework

Executive orders and other directives issued by the Trump Administration will require law-makers to undertake a thorough review of financial regulations, including the post-crisis regulation mandated by the Dodd-Frank Act. The action was taken to address the administration's concerns that existing rules are too costly, limit consumer choice and hinder economic growth. The Core Principles for regulating the US Financial System are detailed in an Executive Order issued by President Trump on February 3, 2017. A separate memorandum also issued February 3requires the Secretary of Labour to revisit the Fiduciary Duty Rule – a rule designed to impose stricter standards on brokers to act in their clients' 'best interest' when providing financial advice.

It is difficult to anticipate the precise timing and possible impact of any rollback in regulations. U.S. banks, as well as Canadian and other foreign banks with operations in the U.S., have already spent billions of dollars complying with Dodd-Frank legislation. Canadian firms have also likely restructured or discontinued business lines, such as their U.S. based proprietary trading, as a result. A possible reversal in U.S. regulations could require Canadian financial executives to revisit past decisions and decide on the best strategic alternatives moving forward.

FINRA Launches Academic Corporate Bond TRACE Data Product

On February 27, 2017 the U.S. Financial Industry Regulatory Authority (FINRA) released a new historical bond data service known as Academic Corporate Bond TRACE Data product. The product is available only to institutions of higher education and encourages academic research on corporate bonds by providing academics with access to TRACE historical transaction-level corporate bond data. The data is available on a 36-month delayed basis and includes masked identifying information regarding the dealer reporting each transaction. The data includes a security identifier as well as information on execution date and time, price, yield, quantity, commission, whether the security was bought or sold, and principal or agency capacity. The product will likely generate new academic research in the field of corporate bond market functioning. While this new research should be welcomed, the extent to which FINRA or other authorities should rely on these studies for policy formation is questionable given the technological and structural changes we see currently shaping fixed income markets in the months and years ahead.

Federal Reserve's Role in Global Regulatory Reforms

Federal Reserve Chair Janet Yellen wrote to House Financial Services Committee Vice Chairman Patrick McHenry (R-NC) in response to his request that the Federal Reserve disengage from international forums on financial regulation such as the Financial Stability Board, the Basel Committee on Banking and Supervision and the International Association of Insurance Supervisors until President Donald J. Trump has had an opportunity to appoint his nominees. Yellen's letter argues that by participating in the development of international regulatory standards, the Federal Reserve can influence the standards in ways that promote the financial stability of the United States and the competitiveness of U.S. firms. The letter further argues the many other benefits strong international standards provide. Yellen's term as Fed chair is scheduled to end in February 2018. Dan Tarullo, another key Federal Reserve board member guiding bank regulation efforts, has announced his resignation for this spring. Who the Trump administration chooses to fill vacancies on the Federal Reserve board could have a significant effect on the Fed's level of involvement in future global regulatory reforms.

Mnuchin Appointed U.S. Treasury Secretary

On Feburary 13, 2017 Steven Mnuchin was sworn in as the 77th Secretary of the U.S. Treasury. Prior to his confirmation, Secretary Mnuchin was Finance Chairman for Donald Trump's presidential campaign. He also served as a Senior Economic Advisor to the President in crafting his economic positions and economic speeches. Much of Secretary Mnuchin career was spent with Goldman Sachs Group, Inc. where he was a Partner and served as Chief Information Officer. Mr. Mnuchin's experience in global financial markets could translate to policy formation that is sensitive to the functioning of capital markets in the U.S. and abroad. One of the first orders of business assigned to him under President Trump's Executive Order will be the review of the U.S. financial regulatory framework to ensure, among other things, that it is efficient, effective and conducive to fostering economic growth.

Europe

FCA Releases Discussion Paper on Primary Capital Markets

The Financial Conduct Authority (FCA) released a discussion paper titled "Review of the Effectiveness of Primary Markets: The UK Primary Markets Landscape." The paper seeks feedback on how the UK primary capital markets can most effectively meet the needs of issuers and investors. Some of the questions posed in the paper include whether there is a role for a UK primary debt multilateral trading facility, and its potential structure and what measures could be introduced to support greater retail participation in debt markets.

Brexit – Operational Impacts on European Wholesale Banking and Capital Markets

AFME commissioned a report from PwC outlining the operational impacts and transformation challenges that Brexit poses to the provision of banking services in the EU. Key findings of the report include that the Brexit process will be highly complex for wholesale banks and covers many interdependent activities. Furthermore, timely approval and transitional arrangements will be needed from EU regulators to ensure financial services are not disrupted. In order to assist the wholesale banking and capital markets, the report makes several recommendations to policymakers including that they clarify with industry participants as soon as possible the structure of any interim business models that may be deemed acceptable immediately post-Brexit.

Research Corner

IOSCO Research Report Examines Bond Trading Platforms

An IOSCO Research Report on Financial Technologies (fintech) includes findings related to electronic trading of fixed income. The report indicates that technological innovation has seen traders embrace electronic trading and a variety of alternative protocols offered to meet bond market needs. While the broader infrastructure is evolving to introduce efficiencies in dealer workflow, it has also created a set of challenges for bond traders in identifying which are the best counterparties and platforms to use for any given trade. The report also indicates that a number of trends can be identified when examining the universe of electronic platforms and the functionality they offer to clients. Specifically, platforms are introducing innovative new protocols in order to increase market participation, identify liquidity opportunities or enhance price discovery. Platforms are increasingly targeting larger-sized trades and are shifting to firm and executable orders. Common market execution conventions with indicative quotes or dealer last look functionality such as Request-For-Quote (RFQ), Request-For-Stream (RFS), and Click-to-Trade are slowly giving way to firm and executable anonymous order books. The report also rightly acknowledges that the proliferation in electronic trading requires regulators to meet the challenge of enhancing monitoring as activity shifts to new trading venues and counterparties.

FCA Releases Paper on Liquidity in UK Corporate Bond Market

The Financial Conduct Authority (FCA) released an Occasional Paper titled "Liquidity in the UK Corporate Bond Market: Evidence from Trade Data." The report suggests there has been a decline in liquidity in the UK's corporate bond market over the past two years, but liquidity still seems relatively healthy in comparison with the entire 2008-2016 period. The analysis, which combines both traditional and non-traditional measures of liquidity, indicates trading conditions have generally become more difficult from 2014-2015 onward. Some of the findings from the research include:

1. A decline in dealer quote rates on electronic bond trading platforms.
2. A slight widening of some quoted and effective bid-ask spreads.
3. An increase in transaction based measures such as the price impact of trades and round-trip costs

The paper counters some of the prior research conducted by the FCA and other regulatory bodies that found little evidence of a decline in market liquidity following the financial crisis.