From the Desk of Ian Russell
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IIAC Fixed Income Market Regulatory Update – January 13, 2016

Canada

The Canadian Securities Administrators (CSA) Extends Approval for CanPX Inc.

- In my December 2015 *Letter from the President*, I discussed the existing CanPX bond market transparency system and the flaws in the new CSA corporate bond transparency proposal. The CSA proposal requires that reporting be done through IIROC's fixed income trade reporting system, the Market Trade Reporting System (MTRS 2.0).
- I stressed that in striking a new direction for corporate bond transparency, the **CSA needs to ensure it understands the full implications of its proposed model and be convinced that the new approach reaches a better public interest objective**. For liquid corporate bonds, the new transparency system is far inferior to the existing CanPX transparency system. Trade information for liquid corporate bonds will be publicly disseminated no earlier than on T+1 and, likely, on T+2 (i.e. two days following the trade). However, dissemination of trade information on CanPX is with a one-hour delay. Moreover, the **CSA's decision to move away from CanPX would deprive the market of real-time prices for Canadian government securities**.
- The optimal approach would seem to be an amalgam of the proposed transparency approach based on the new IIROC Market Trade Reporting System and the CanPX transparency system.
    - CanPX was approved as the information processor for corporate fixed income securities in 2003 and has been subject to rigorous oversight and audit by the CSA since then. Its approval was set to expire on December 31, 2015. On December 29, 2015, the CSA announced that it is extending CanPX's status as the information processor for corporate debt securities for a period of six months—until June 30, 2016.
    - Regulators are currently reviewing the comments received on their initial proposals. They expect to publish additional information about the timing of the dissemination of the post-trade information, as well as details regarding what this information would include, in the first quarter of 2016.

Bank of Canada's *Financial System Review* (FSR)

- In its December 2015 FSR, Canada's central bank **highlighted vulnerabilities and potential triggers that pose risks to the Canadian financial system**. Two vulnerabilities relate to the Canadian household sector—the elevated level of household indebtedness and imbalances in the housing market. **The third vulnerability relates to uncertain market liquidity in fixed-income markets** (both the decline in its level and its greater fragility). A new risk of prolonged weakness in commodity prices has been added, while the risk associated with severe financial stress in the euro area has been removed.
- The Bank noted that fixed-income markets in Canada and elsewhere are perceived to be more prone to bouts of illiquidity. A sudden drop in market liquidity could contribute to wild swings in prices, triggering widespread portfolio adjustments among investors. It could negatively impact other asset classes and market participants.

- It appears the level of liquidity remains largely unchanged for benchmark Government of Canada (GoC) bonds, but has declined for non-benchmark GoC bonds and corporate bonds.
- Investors have indicated that it takes more time to execute large transactions than in the past, particularly in the corporate bond market, and investor behaviour has altered to account for changes in liquidity.
- Investment funds, such as mutual funds and exchange-traded funds, have grown in size and now account for a larger portion of bond markets. **Fixed-income mutual funds have attracted attention in many jurisdictions because, in some cases, they offer on-demand redemptions even when funds hold relatively illiquid securities**. Periods of tumultuous and uncertain market conditions would trigger substantial mutual fund redemptions and more pronounced price swings in the bond markets. However, the Bank stated **mutual funds in Canada are not highly leveraged nor have serious liquidity mismatches**. While mutual funds hold more illiquid assets, they also tend to hold more cash and cash equivalents to meet redemptions, and regulations restrict their leverage.

United States

FINRA Research on the State of U.S. Corporate Bond Market Liquidity

- On December 10, 2015, the Washington-based Financial Industry Regulatory Authority (FINRA) issued new research on the state of liquidity in the U.S. corporate-bond market. It analyzed all Trade Reporting and Compliance Engine (TRACE) corporate bond transactions from 2003 to September 2015.
- FINRA concluded: "**While the data indicate a robust market, they also highlight several areas of potential emerging risk that merit more attention and further study**…These issues include increased electronic trading in corporate bonds, the volatility of bond ETFs and sector-specific problems in high yield originating in the energy sector."
- Some **notable research findings**:
  - There have been significant changes in how the market works, including smaller average trade size and declining proportion of bonds traded in blocks of $5 million or more. Average trade size for the 1,000 most active issues dropped almost 35% between 2007 and 2013, and the proportion of total volume traded in blocks of $5 million or more fell by almost 15%.
  - Between 2003 and 2007, the percentage of newly issued bonds remained below 20%. Since 2011, newly issued bonds represent an average of 45% of the most actively traded portion of the secondary market.
  - Block trading levels in 2015 represent near record high totals for both the $10 to $25 million, and the $25 million and up category.
  - Estimates of bid-ask spreads have fallen steadily since trades began to be disseminated though TRACE, except in 2007-2008. Bid-ask spreads reached record lows in 2014. There was a slight increase in 2015, but it is estimated to be under two basis points in both market segments.
  - In 2007, a dealer traded with 15.4 counterparties, on average. By 2012, this had risen to more than 26, an increase of almost 70%. This number has remained stable over the last three years, even as the total number of dealers has declined.
- For additional findings and analysis, as well as graphs, click here.

FINRA's *2016 Regulatory and Examination Priorities Letter* Identifies Areas of Concern in Fixed Income Markets

- The U.S. Financial Industry Regulatory Authority **(FINRA) is aware of instances in which municipal bond underwriters have taken new issues into inventory and then improperly offered them to customers at higher prices after trading commences in the secondary market**. The SEC recently levied significant sanctions against a municipal underwriter for this type of misconduct.

- In 2016, **FINRA will review whether firms have processes in place to ensure that investors are treated fairly, that firms are complying with fair pricing obligations** and that they conduct *bona fide* public offerings. FINRA will monitor the primary market sales reported by syndicate participants relative to issuance size. FINRA will also assess secondary market trading, particularly by syndicate participants, subsequent to the completion of the offering to ensure customers are receiving fair and reasonable prices.
- **FINRA will also focus on settlement practices for fixed income trades** to understand how the operational and credit risks are managed when large trades are executed away from the prime broker. It will explore industry practices with respect to disaffirming trades and the legal documentation that supports the settlement process. **It will also consider financing practices for fixed income where extensive leverage is offered**.
- **FINRA will continue to review fixed income order handling, markups and related controls**. It will augment its best execution surveillance by implementing spread-based surveillance patterns in 2016. **Other areas of increased focus include wash sales, marking the close and trading ahead**. FINRA will continue to review fixed income alternative trading systems (ATSs).
- FINRA will also put more focus on culture in individual firms and the role of culture in putting the client first, and in managing risk and conflicts of interest.
- Additional information is available by clicking here.

Municipal Advisor Core Conduct Rule

- The U.S. Municipal Securities Rulemaking Board (MSRB) creates rules of conduct and standards of qualification for municipal advisors.
- The Board's Rule G-42-Duties of Non-Solicitor Municipal Advisors was approved by the U.S. Securities and Exchange Commission (SEC) on December 23, 2015, and takes effect June 2016.
- Under Rule G-42, **a municipal advisor is subject to a fiduciary duty that includes a duty of loyalty and a duty of care** (as established under the *Dodd-Frank Wall Street Reform and Consumer Protection Act*) when dealing with municipal entity clients. The duty of loyalty requires a municipal advisor to act in the municipal entity client's best interest without regard to the financial or other interests of the municipal advisor. **Advisors must also provide written disclosure of conflicts of interest and they must conduct reasonable diligence to support the suitability of recommendations**.
- The proposed Rule G-42 **prohibited a municipal advisor, or a broker dealer affiliate, acting as a principal in a transaction with a municipal issuer client for which the advisor is directly providing advice**. This provision was amended to include a narrow exception that generally covers transactions in particular types of fixed income securities where the municipal advisor follows a process to make disclosure and obtain client consent.
- The SEC's approval order can be read here.
- You can read more about MSRB's municipal advisor rulemaking by clicking here.

Europe

Bank of England *Financial Stability Report* (FSR)

- In its December 2015 FSR, the **Bank of England stated there is evidence market and liquidity risks may not be fully baked into the prices of some financial assets**. Indeed, the compensation investors require to bear the liquidity risk associated with corporate bonds remain around historical norms. The concern is that spreads could overshoot in the event of a disorderly market correction. This could arise, for example, if there are large-scale investment fund redemptions.

- Some markets appear to have become more fragile reflecting episodes of increased short-term volatility and illiquidity. Recent episodes of short-term volatility and illiquidity having centred on fast, electronic markets.
- The independent Financial Policy Committee (FPC) at the Bank of England will **continue to review the activities of investment funds and will assess the impact of regulatory reforms on the provision of market liquidity**.
- You can access the FSR by clicking here.

Meetings with IOSCO and the FICC Markets Standards Board

- I will be in London UK in the spring to meet with the new Secretary General of the International Organization of Securities Commissions (IOSCO), Paul Andrews. I will also take the opportunity to meet with Elizabeth Corley. She is the Global Chief Executive Officer of Allianz Global Investors and the Chair of the Fixed Income, Currencies and Commodities (FICC) Markets Standards Board.
- The purpose of the meeting with Ms. Corley is to **get a better understanding on progress in implementing the key recommendations in the Fair and Effective Markets Review (FEMR) and the implications for the Canadian capital markets**.
- The FICC Markets Standards Board was set up on the recommendation of the FEMR—a joint review initiated by the UK Chancellor of the Exchequer, the Bank of England and the Financial Conduct Authority—to raise standards in FICC Markets.
- I will provide an update on our conversation in a future edition of the *IIAC Fixed Income Market Regulatory Update* newsletter.

Asia

Asian Financial Forum

- I have been invited to lead the Canadian delegation to the annual Asian Financial Forum in Hong Kong on January 19-22, 2016.
- I will meet with Mushtaq Kapasi, Head of the International Capital Market Association (ICMA) Asia-Pacific to discuss fixed income markets in the Far East and, in particular, joint jurisdictional efforts to improve debt market transparency following the EU lead.
- I will also meet with Ashley Alder, CEO of the Hong Kong Securities & Futures Commission and Chair of the International Organization of Securities Commissions (IOSCO) Task Force on Cross-Border Regulation to **understand IOSCO's next steps to resolve OTC derivatives cross-border implementation issues, including overlapping regulatory regimes**.
- The outcome of these conversation will be reported in a future edition of the *IIAC Fixed Income Market Regulatory Update* newsletter.

China to Stress Test Securities and Futures Institutions

- The China Securities Regulatory Commission (CSRC) said on Dec 18, 2015 that it plans to **stress test its brokerages, mutual funds and commodity futures institutions** to assess how they perform under extreme conditions.
- Assumptions of wide swings in the capital market or widespread defaults in the bond market will be among the scenarios considered.
- The stress tests will provide information with which CSRC can adjust policy and lessen risks.

Singapore Exchange (SGX) Launches SGX Bond Pro

- In December 2015, the Singapore Exchange (SGX) launched SGX Bond Pro, the **first Over-The-Counter (OTC) electronic trading venue for Asian bonds**.
- SGX Bond Pro platform commenced with trading of Asian credits in G3 currencies, followed by Asian local currency bonds.
- To cater to the different needs of these participants and **deliver enhanced liquidity in Asian bonds**, SGX Bond Pro offers multiple market places and trading protocols that are facilitated via the General Counterparty.
- Additional information is available here.

India Proposes Primary Market Debt Offering Through Private Placement on Electronic Book

- At the Corporate Bonds and Securitization Advisory Committee (CoBoSAC) meeting held in July 2015, the Securities and Exchange Board of India (SEBI) proposed the introduction of an **electronic book for primary market debt offering through private placement**. The Committee, in-principle, accepted the proposal and recommended the initiation of public consultation process on the proposal. SEBI launched consultations in December 2015.
- An electronic book should result in more efficient price discovery, reduction in cost and time taken for issuance, and greater transparency.
- Additional information is available here.

The Investment Industry Association of Canada (IIAC)
Representing Canada's Investment Dealer Firms

The Investment Industry Association of Canada (IIAC) is the national association representing the position of 144 IIROC-regulated Dealer Member firms on securities regulation, public policy and industry issues. The IIAC has successfully argued for positive change in securities regulation and public policy that has improved market efficiency and lowered costs for dealers and market participants without jeopardizing investor protection. See the Highlights of Our Achievements report.

The IIAC's efforts have assisted Member firms address:

- CRM rule-making and managing industry CRM compliance effort
- Cyber threats
- Tax reporting requirements (e.g. FATCA, OECD Common Reporting Standard, and Specified Foreign Property Tax Reporting)

The IIAC has also taken a leading role among trade associations in laying out the rationale for a cooperative securities regulator, pension reform and OTC derivatives reform with positive results.

The IIAC has established two Operations and Technology Committees—the *Equity Infrastructure Committee* and the *Market Data Committee*—to provide a forum for firms to discuss emerging technology trends and innovations affecting the industry and to identify opportunities for industry project collaboration.

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