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IIAC Fixed Income Market Regulatory Update

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Canada

Bank of Canada's Survey Findings on Market Liquidity, Transparency and Market Access

- **Survey respondents' impressions of current market liquidity**:
    - Government of Canada benchmark bonds are generally perceived to be the most liquid asset class.
    - Perceptions of liquidity across other asset classes are more varied, depending on the type of institution, trading approach and location.
    - Sell-side participants place somewhat greater emphasis on their ability to execute without moving the market, while buy-side participants are more concerned with the amount of liquidity available on an average day.
- **Survey respondents' impressions of market liquidity over the last two years**:
    - Liquidity is perceived to have declined only slightly for futures and Government of Canada benchmark bonds, and deteriorated most for investment grade corporate bonds.
    - Roughly 50% of all buy-side participants have seen a change in their Canadian dollar fixed-income portfolio management activities in response to changes in market liquidity. Most market participants have altered their corporate bond trading execution strategy.
    - Roughly 40% of market participants have noted a change in their Government of Canada bond execution strategy in response to changes in market liquidity. Close to 80% of sell-side participants noted a change in their Government of Canada bond execution strategy.
    - More than 40% of sell-side participants have changed their Canada Mortgage Bond and/or provincial bond execution strategy in response to changes in market liquidity.
    - Close to 70% of participants have been unsuccessful in executing a Canadian dollar investment grade corporate bond trade within a reasonable (or expected) period of time.
    - About 30% of buy-side participants are doing more short-term tactical trading to take advantage of market dislocations, especially in Government of Canada securities. More participants are considering doing so.
- **Large sell-side firms indicate relatively unchanged inventories** across all asset categories over the last two years.
- About **60% of participants indicate either a somewhat or significant increase in their share of corporate bond trading done on an agency basis** over the last two years.

- Over **55% of debt-issuers report a change in their ability to issue fixed income securities** due to changes in the underlying liquidity of fixed income securities or changes in market structure.
- Additional information is available here.

IIAC's Comments on the Investment Industry's Readiness for Meeting a Two-Day (T+2) Settlement Cycle

- In recent years, the global financial industry has increased efforts to mitigate operational and systemic risk in capital markets. One way to do so is to settle trades more quickly, thereby reducing counterparty risk.
- Canada has committed to shortening the securities settlement cycle from the current three days to two days. The move to a T+2 settlement cycle is expected to occur on September 5, 2017, at the same time as U.S. markets move to a T+2 settlement cycle.
- On November 11, 2016 the IIAC submitted comments to the Ontario Securities Commission and the Autorité des marchés financiers on the move to T+2.
- The IIAC noted that **Canada's investment industry is already largely capable of meeting a T+2 settlement cycle**. They have gone to great lengths over the past several years to eliminate, to the extent possible, any manual processes within their firms.
- The **IIAC did not support the introduction of "fail charges"** as a mechanism to address settlement failures.
- To further support a shortened settlement cycle, the **IIAC encouraged all parties to a trade to be utilizing electronic communication** to report trade details.
- You can view the IIAC's submission here.

United States

SEC and FINRA Mandate the Inclusion of Treasury Bonds in TRACE

- In mid-October, the U.S. Securities and Exchange Commission (SEC) approved the Financial Industry Regulatory Authority (FINRA)'s proposal to require its members (nearly 4,000 banks and brokers registered with FINRA) to **report certain transactions in Treasury Securities to FINRA's Trade Reporting and Compliance Engine (TRACE)**. FINRA has set July 10, 2017 as the implementation date.
- The U.S. Treasury has committed to develop a plan by year-end 2016 for comprehensive, timely collection of trading data for cash Treasuries, with the ability to share that data across agencies to interpret market dynamics.
- The volatility in Treasury markets on October 15th, 2014 (i.e. the "flash crash") highlighted major constraints in readily available data.
- **FINRA reporting will capture roughly 90% of Treasury market transactions**, including trading on major platforms, such as BrokerTec and eSpeed.
- **Non-FINRA member participants are not subject to reporting requirements**. This includes unregistered Principal Trading Firms (PTFs), banks, and unregistered trading platforms. The Treasury stressed that **rules on reporting trades should cover PTFs** so there is a level playing field for reporting requirements.

- PTFs account for a majority of the trading volume in the inter-dealer market. While data collection from inter-dealer platforms will capture PTF trades, it will not provide the participant-level granularity that would accompany direct PTF reporting—granularity that is critical for monitoring market dynamics.
- One critical question is whether and how Treasury data should be disseminated to the public. The **concern is that transparency would impair liquidity in the secondary market** and **increase the costs of market making**. Those that favoured greater public transparency highlighted the enhanced potential for market participants to assess quality of execution, promote competition, encourage new entrants, strengthen risk management practices, and foster a more resilient market structure.
- Treasury futures, agency debt, agency MBS and other securitized products, corporate bonds, and interest rate swaps have already instituted post-trade transparency.
- **To manage potential risks, the Treasury recommends appropriate time delays to reporting and dissemination of data; a cap on the size of trades disclosed (i.e. on block trades that produce excessive price movement); and gradual phasing in of public transparency**. The implementation of TRACE for corporate bonds took more than three years, and involved extensive consultation and adaptation along the way.
- Background information on the rule change relating to the reporting of U.S. Treasury securities to TRACE is available here.

Federal Reserve Bank of New York Moves to Expand the Pool of Primary Dealers

- The New York Fed announced **three changes to the eligibility criteria for primary dealers**. These changes are effective immediately.
    - The **minimum net regulatory capital (NRC) threshold for broker-dealers has been reduced** from $150 million to $50 million.
    - The **minimum Tier 1 capital threshold for banks and branches and agencies of foreign banking organizations has been raised** from $150 million to $1 billion, to better align the Tier 1 threshold with the new NRC threshold. The threshold is measured with respect to Tier 1 capital of the bank holding company.
    - A 0.25 percent **minimum Treasury market share threshold has also been introduced** as a means to more directly quantify the business capabilities of firms that express interest in becoming a primary dealer.
- More information about the new policy and changes can be found in the frequently asked questions.

The SEC Approves Proposal Requiring Dealers Who Buy or Sell Municipal Securities to Disclose Their Mark-ups or Mark-downs

- The Securities and Exchange Commission (SEC) approved Financial Industry Regulatory Authority (FINRA) and Municipal Securities Rulemaking Board (MRSB) rule amendments requiring dealers to disclose trade compensation for certain fixed income securities principal transactions with retail investors.
- The rule changes are an effort to improve investors' ability to assess the overall cost of transacting in municipal bonds (i.e. improve transparency).

- The **amended rules require dealers to disclose their mark-up or mark-down from the "prevailing market price" of the security for the purpose of calculating their compensation**. The rule amendments also provide guidance on determining the "prevailing market price" for a security.
- **The rule amendments establish a waterfall or hierarchy of factors for determining "prevailing market price"**. Dealers would:
    - Look at their contemporaneous trades of the same municipal security with other dealers or customers
    - Look at contemporaneous trades of the municipal security in interdealer trades
    - Look at trades of the municipal security between other dealers and institutional investors
    - Look at trades on alternative trading systems or other electronic platforms
    - Look at contemporaneous trades of similar securities. "Non-exclusive factors", like credit quality, size of the issue, and comparable yield, could be used to determine if securities are similar.
    - Use prices or yields derived from economic models.
- **The industry has criticized the rule changes**, stating they are overly complex, costly and could potentially harm market liquidity.
- **Dealers noted that it will be difficult to automate a compliance system** to take into account the waterfall of factors for determining "prevailing market price".
- The industry has 18 months to work on a number of compliance issues.

Europe

ICMA Makes Recommendations to Expand and Enrich Analysis of Bond Market Liquidity

- According to Andy Hill, Senior Director at the International Capital Markets Association (ICMA), bond market liquidity is widely discussed, but sourcing reliable data for analysis and producing verifiable conclusions is challenging.
- Hill noted that the International Organization of Securities Commissions (IOSCO) did not find substantial evidence showing that liquidity in the secondary corporate bond markets has deteriorated markedly from historic norms for non-crisis periods. Hill stated that ICMA's conclusions differ from IOSCO's for a number of reasons.
    - First, **corporate bond markets across different jurisdictions have very different characteristics** in terms of market structure, participant composition and liquidity dynamics. It is **difficult to draw meaningful conclusions based on aggregate data**. As much as possible, analysis should be based on specific markets and within the same jurisdictions to ensure relevance of any conclusions.
    - Second, in the European market, at least, **prices quoted on screens are rarely executable**. They are at best indicators for where small sizes might be traded, and at worse completely meaningless. Often dealer runs that feed onto platforms are not updated on a regular basis, while quotes can be adjusted or pulled by dealers when a counterparty tries to execute on them.
    - Third, even if one assumes that bid-ask spreads are reliable indicators of where markets will clear, one will find that **the trend in nominal bid-ask spreads appear to have narrowed relative to the underlying yields of the bonds (an indicator of improved**

liquidity), but real terms bid-ask spreads have actually widened (an indicator of deteriorating liquidity). A time-series analysis of relative bid-ask spreads across jurisdictions might be far more informative.
  - Lastly, a number of ICMA's buy-side member firms has stated that perhaps **the important indicator of liquidity is not so much what has traded, but rather what could not be traded**. "Dropped trades" and unfulfilled orders are far more revealing variables for determining and measuring liquidity.
- For more information, see IOSCO's Consultation Report: *Examination of Liquidity of the Secondary Corporate Bond Markets* and ICMA's *Response* to the IOSCO Consultation Report.

European Fixed Income Trading Platforms Partner to Create New Association

- BrokerTec Europe Ltd, MarketAxess Europe Limited, MTS Group and Tradeweb Europe Limited launched the Electronic Debt Markets Association Europe (EDMA Europe).
- The **members of ESMA will develop collective views on regulatory developments** affecting electronic fixed income trading venues in Europe, and ultimately investors and dealer clients of multilateral trading facilities.
- Association **members will provide market data to the regulators for transaction cost analysis**. MiFID II will require dealers to provide more evidence to their clients on how they tried to achieve best execution.
- Additional information is available on EDMA Europe's website http://www.edmae.org/

Asia

ASIFMA's Global Survey Findings on Investors' Interest in Mainland China's Onshore Bond Market

- A survey conducted by the Asia Securities Industry and Financial Markets Association (ASIFMA) indicated that **liquidity in China's secondary bond market and free flow of capital across borders are the two biggest concerns of global investors** considering investing in China's onshore bond market.
- The survey collected responses from more than 100 investors worldwide, representing total estimated global assets under management of over US$21 trillion.
- The survey found **51% of respondents are already investing in China's onshore bond market**, while **33% are not investing, but are planning to inves**t in the next 12 months. Only 15% of respondents have no plans to invest in the country over the next 12 months.
- Additional survey results are 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 133 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.

The IIAC's efforts have assisted Member firms address:

- CRM rule-making and managing industry CRM compliance efforts
- 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.

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