



INVESTMENT INDUSTRY ASSOCIATION OF CANADA
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LETTER FROM THE PRESIDENT

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Some Thoughts on the Recent CSA Proposal for Corporate Bond Transparency

HIGHLIGHTS:

In striking a new direction for corporate bond transparency, the CSA needs to ensure it understands the full implications of its proposed model.

The IIROC debt surveillance system that underpins the new transparency model is unlikely to provide sufficient flexibility needed for an effective transparency system.

The optimal approach would seem to be an amalgam of the proposed transparency approach based on the new IIROC surveillance system, and the CanPX transparency system.

In September 2015, the Canadian Securities Administrators (CSA) released its long-awaited proposals to enhance corporate bond transparency. The approach is a departure from the existing transparency model for Canadian debt markets and could lead the initiative in a different direction in future years. The CSA has decided to build a transparency engine for debt markets on the foundation of the IIROC Market Trade Reporting System (MTRS 2.0). In the first stage, effective mid-2016, dealers and their affiliates that are Government Securities Distributors will be required to report bond transactions to the self-regulator. All other dealers will be required to report their transactions in the second phase of implementation of the debt reporting system, effective mid-2017.

In its decision to strike 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. Further consultation and thought are needed on both points.

As a starting point, it is appropriate for the CSA to examine the adequacy of the existing transparency system in corporate debt markets and consider alternatives to determine representative bond prices in the markets to help investors and their advisors make the right investment decisions, particularly given the opaqueness of over-the-counter debt markets. It should also be recognized that Canadian regulators have taken a responsible and leading approach to bond transparency in recent years. For the past fifteen years, the CSA encouraged the investment industry to build and manage the CanPX transparency system—well before the European regulators even addressed the subject, and before the U.S. regulators

imposed the TRACE system for corporate bonds. The IIAC serves as corporate secretariat for CanPX.

The CanPX transparency system

Since the late 1990s, Canadian regulators have forced steadily higher standards on CanPX and subjected the system to a comprehensive and ongoing audit and oversight process.

The regulators, together with a cross-section of market participants, expanded the breadth of bond transparency in domestic fixed income markets. The CanPX system now consists of: 1) non-mandated comprehensive real-time pre-trade and post-trade bid-offer prices, and post-trade prices and related traded volumes, for federal and provincial government bonds; and 2) mandated post-trade prices for approximately 450 corporate bonds selected for their relative liquidity and investor preference in the marketplace (with traded volume caps of \$2 million for investment grade and \$200,000 for non-investment grade corporate debt securities). These designated bonds are estimated to account for approximately two-thirds of corporate bonds traded.

It is anticipated that CanPX's regulatory status as an information processor will be extended to mid-2016, with a possible extension, and will then be replaced with the proposed new transparency model. Without the designation, dealer participation in CanPX will likely fade bringing with it an end to the CanPX corporate bond transparency service. This may also cause CanPX to shut down its government bond transparency service resulting in less transparency in government bond markets. There is currently an exemption in place from mandated transparency in government debt markets until January 1, 2018.

On initial reflection, a transparency approach driven off a regulatory reporting system for all bonds traded in the marketplace, and modified over time through strategic adjustments based on consultation with market participants, carries a certain logic.

However, the key element for any transparency system is its flexibility to adjust the degree of mandated transparency to safeguard the underlying liquidity of the bond. Flexibility in the transparency mechanism is essential to ensure that the extent of transactional information provided and timing of release of that information does not undermine the underlying liquidity of the bond. The appropriate information quotient for different characteristics of corporate bonds has been the subject of intense regulatory debate in the European and U.S. corporate bond markets. Europe, for example, proposes imposing a liquidity test and criteria to determine the degree of transparency of bonds. The sensitivity to impacting bond liquidity, defined as the ability to post new bid and offer prices proximate to the last traded price, has become a more acute concern with the recent and ongoing deterioration and thinning out in secondary corporate debt markets.

The CanPX transparency system has always recognized this principle of modified transparency, with the volume caps for traded corporate bonds, a one-hour delay in transaction reporting for liquid corporate bonds, and gradual expansion of the list of less liquid bonds posted on the CanPX system—a process decided through consultation with an advisory committee of dealer and buy-side participants, and the regulators. CanPX also has a website that provides investors free access to daily bond prices. The decision to move methodically and carefully in expanding the list of CanPX-reported bonds has, in fact, from time-to-time, subjected the CanPX system to criticism that the list of bonds was expanding too slowly, even though most liquid corporate bonds with a retail interest are now reported.

Flaws in the proposed system

The IROC debt surveillance system that underpins the new transparency model is unlikely to provide sufficient flexibility needed for an effective transparency system. By basing the platform for corporate debt transparency on MTRS 2.0, trade information will be publicly disseminated on T+2 (i.e. two days following the trade) to give the reporting dealer and IROC the time needed to collect and process the information. The delay for transparency purposes could be extended beyond two days for certain illiquid bonds, say, those traded mainly on an agency basis, or excluded altogether from the transparency mechanism.

The CSA Proposal also recognizes the dissemination delay could be shortened for liquid bonds through a corresponding adjustment in the IROC bond reporting system, namely a mandated faster reporting time for corporate bonds, say, reporting on T+1 settlement. Such an adjustment, however, could only be accomplished through costly modification to the debt reporting system. Further shortening in the dissemination period to accommodate an even faster release of information becomes

impractical. More to the point, the IROC debt surveillance system, driving the new proposed transparency system, could never match the one-hour delay in disseminating trade information for designated liquid corporate bonds now reported through the CanPX system.

The CSA recognizes this dissemination constraint of the proposed reporting system, but argues that reporting all corporate bonds through the MTRS 2.0 system, even with a two-day reporting lag, is preferred to an approach that provides more timely price dissemination through some alternative arrangement for liquid bonds that trade frequently intra-day in the markets. The IAC takes issue with this proposition, stressing in its submission to the CSA that dissemination of information on all corporate bonds, even with a two-day reporting lag, risks jeopardizing the market-making activities for illiquid corporate bonds that result in extended market exposure to dealing firms. Perhaps more importantly, retail investors rarely trade the large number of illiquid bonds in the marketplace. On the other hand, the mandated two-day reporting period for liquid corporate bonds disadvantages retail investors by the lack of timely information to make trading decisions on an intra-day basis.

The optimal transparency approach

The optimal approach would seem to be an amalgam of the proposed transparency approach based on the new IROC surveillance system, and the existing CanPX transparency system. The IROC reporting system could provide traded corporate bond prices, with appropriate volume caps and lagged T+2 settlement time, for a sub-set of reported bonds determined through consultation with market participants. In this regard, some of the more illiquid bonds could be excluded from the T+2 delay for an extended period, or excluded altogether. However, in this scheme, the CanPX transparency system would still retain its status as an approved transparency system, subject to regulatory oversight and audit. CanPX would continue to publish real-time prices and volume for Canadian government securities, and an agreed list of corporate securities of varying liquidity with a volume constraint. This list of approximately 450 corporate bonds would be released with an hour lag.

The list could be expanded beyond the 450 bonds to include less liquid traded bonds, with the regulators, together with market participants, deciding on the additional corporate bonds for inclusion and the dissemination delay for these less liquid bonds. The judgement should take into account the fact transparency is designed foremost to assist smaller institutions and less sophisticated retail investors and their financial advisors find the representative market price. Moreover, the proposed expansion of the CanPX system should recognize retail investors typically purchase corporate debt securities through mutual funds and ETFs, obviating the need for extensive transparency of more obscure and infrequently traded corporate debt securities.

The decision to retain the CanPX system would also avoid addressing some thorny questions. For example:

- Would the existing CanPX transparency system with its extensive dissemination of traded government and corporate bonds continue to operate if its official status as an approved transparency system were discontinued?
- If the proposed transparency system bolted onto the IIROC debt surveillance system became the sole official transparency vehicle, with information then sold to interested information vendors and other third parties, which entities would be entitled to related revenues?
- What would be the cost estimates for ongoing structural adjustments to the IIROC debt surveillance system to conform to changing transparency demands, and who would pay for them?

Conclusion

It is timely to undertake a full review of the corporate bond transparency system given the regulatory focus on market transparency in many jurisdictions, the shifting retail investor interest in purchasing investment funds, such as ETFs, rather than individual securities, and the new IIROC debt surveillance reporting system for debt markets. The regulators need to find an approach that provides the needed flexibility to match the transparency regime to the frequency of bond turnover to avoid undermining liquidity.

The IIROC surveillance system provides a useful vehicle for transparency as long as precautions are taken in the dissemination of the bond information. However, this surveillance system does not provide the required flexibility to ensure effective bond transparency to meet the needs of investors trading in liquid and illiquid corporate bonds. The existing CanPX transparency scheme, that has delivered understated value to fixed income markets for years, should retain approval and oversight of the regulators, in conjunction with the proposed transparency approach, to ensure the needs of the marketplace are met.

Yours sincerely,



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