FIXED INCOME MARKET REGULATORY UPDATE

July 2017

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

Canada

IIROC Expands its Corporate Debt Transparency Service

On July 6, 2017, IIROC announced it has launched the next phase of its corporate debt transparency system by expanding the information available on its corporate bond web site. The site now includes all corporate debt trades by all IIROC-regulated firms for retail and institutional clients. All trades continue to be consolidated across firms, de-identified and published on a two-day lag. Information published includes: Execution Date, Execution Time, Volume (which is subject to a cap on size), Price and Yield. Trades are also identified as 'retail' or 'institutional' and whether a commission was incurred on the trade. There is currently no indication whether these information parameters will change over time. IIROC is providing the trade details above in its role as Information Processor for corporate debt markets which it assumed in July, 2016. The cost of operating the transparency system is fully borne by IIROC dealer members. Little visibility, however, has been provided by IIROC or the CSA regarding the extent to which investors have used the corporate bond website and whether it's meeting the regulators' expectations for increasing transparency of corporate debt markets.

The current exemption for mandated transparency on government debt markets expires on January 1, 2018. The Commissions and the Bank of Canada will, therefore, soon have to determine what transparency framework to adopt for this sector of the market. Their decision will have to balance market participant's need for price discovery without impairing market liquidity.

Canadian Monetary Policy

On July 12, 2017, the Bank of Canada (BoC) raised its key policy rate by 25 basis points to 0.75 per cent. The BoC cited in its decision an economy that is approaching full capacity and inflation that is expected to reach the 2 per cent target within the next year. The BoC's move was the first-rate increase in seven years. The BoC will likely be cautions in further policy adjustments given stubbornly weak inflation rates and concerns in our housing market.

The BoC's comprehensive outlook for the Canadian economy and the forces shaping it are detailed in its Monetary Policy Report.

United States

FINRA Launches Reporting of Treasury Transactions

On July 10, 2017, the Financial Industry Regulatory Authority (FINRA) implemented requirements for its member firms to report secondary-market transactions in Treasury securities (except savings bonds) to TRACE, FINRA's Trade Reporting and Compliance Engine. The information required will be largely similar to what is currently provided by its members for corporate debt securities. At this time, FINRA is not charging transaction-level fees and is not publicly disseminating information on transactions in Treasuries. FINRA states it is including the information in the TRACE regulatory feed it provides to federal financial agencies in order to enhance their oversight and knowledge of the Treasury markets. The way the federal agencies will use the data is uncertain, but analysis stemming from the data could influence policy making. Given the moves other jurisdictions, notably Europe, are making to mandate increased transparency of debt markets, including that of government debt, it should not be unexpected if FINRA decides at some future date to begin publicly disseminating information on Treasuries.

FINRA Guidance on Planned Fixed Income Pricing Disclosures

Beginning in May, 2018, FINRA members will be subject to new requirements whereby member firms must disclose additional transaction-related information to retail customers for trades in certain fixed income securities. Specifically, members are to disclose the amount of mark-up or mark-down it applies to trades with retail customers in corporate or agency debt securities if the member also executes an offsetting principal trade in the same security on the same trading day. Members will also have to disclose: (1) a reference, and a hyperlink if the confirmation is electronic, to a web page hosted by FINRA that contains publicly available trading data for the specific security that was traded, and (2) the execution time of the transaction, expressed to the second.

FINRA says it has worked closely with the Municipal Securities Rulemaking Board (MSRB) to develop similar rules, as appropriate, to ensure consistent disclosures to customers across debt securities and to reduce the operational burdens for firms that trade a variety of fixed income securities.

To assist its Members in meeting the new requirements, FINRA recently published an FAQ which addresses such as areas as:

- when the disclosure requirements are triggered;
- the scope of securities and transactions subject to the disclosure requirements;
- the required content and format of disclosure under the requirements; and
- the determination of prevailing market price.

SEC's Focus on Fixed Income Market Structure

In his first public speech as Chairman of the Securities and Exchange Commission (SEC), Jay Clayton announced that the "time is right" for the SEC to broaden its review of market structure to include, specifically, the efficiency, transparency, and effectiveness of fixed income markets. Clayton sited the wave of aging retiring baby boomers relying on fixed income products but who may not appreciate that they differ significantly from the better-known

equities markets. Clayton said that the SEC must explore whether these markets are as efficient and resilient as expected and identify opportunities for improvement. Clayton has asked staff to develop a plan for creating a Fixed Income Market Structure Advisory Committee made up of a diverse group of outside experts, who will be asked to give advice to the Commission on the regulatory issues impacting fixed income markets.

House Subcommittee Examines Efficiency of Fixed Income Markets

On July 14, 2017, the House of Representatives Subcommittee on Capital Markets, Securities, and Investment held a hearing entitled "A Review of Fixed Income Market Structure". According to the Subcommittee's Memorandum, the objective of the hearing was to provide the Subcommittee with the background and foundation to examine the optimal design of the fixed income market based on current market conditions.

The Subcommittee heard testimony from several market participants. The Securities Industry Financial Markets Association (SIFMA) presented that fixed income markets face challenges in continuing to provide the deep liquidity and capital that consumers, businesses, and investors require. Well-meaning capital standards could drive dealers to deplete the supply of high-quality assets available to investors as they seek to comply with new regulatory requirements, testified Randy Snook, SIFMA's Executive Vice President. In order to ensure the continued depth and diversity of the fixed income markets, SIFMA recommends policymakers review the many regulatory and prudential actions taken since the crisis with a goal to eliminate overlapping or conflicting regulation, capital requirements, and unnecessary activity restrictions. SIFMA also believes that the Volcker Rule as drafted and implemented has impaired beneficial activities (such as permitted market-making) and has led many firms to scale back their trading operations as well as their inventories of financial assets.

Fed Guidance on Volker's "Seeding" Period for Covered Funds

On July 24, 2017, the Federal Reserve Board (Fed) announced guidelines for banking entities seeking an extension to conform certain "seeding" investments in hedge funds or private equity funds (covered funds) to the requirements of the Volcker Rule. Seeding refers to the period during which a banking entity provides a new fund with initial equity to permit the fund to attract investors. In an attempt to shelter banks with federal deposit insurance from riskier trading activity, the Volcker Rule generally prohibits them from holding major investments in covered funds. One exemption is that banks are allowed to provide temporary "seeding" investments to help start up such funds. However, banks are required to actively seek unaffiliated investors to reduce its investment in the covered fund, no later than one year after the date of establishment of the fund to an amount that is not more than three per cent of the total outstanding ownership interests in the fund. But banks can apply for up to a two-year extension with the Fed. The guidance issued provides information on the procedures for submitting an application for an extension of the one-year seeding period.

Market Liquidity After the Financial Crisis

The Federal Reserve Bank of New York's Research and Statistics Group published a blog post entitled "Market Liquidity after the Financial Crisis." The authors find that dealer balance sheets have continued to stagnate and that various measures point to less abundant funding liquidity. Nonetheless, they do not find clear evidence of a widespread deterioration in market liquidity. However, they note that dealer balance sheets have changed dramatically, and some funding cost metrics, such as the CDS-bond basis, imply increased balance sheet costs, suggesting important changes in dealer behavior. Similarly, the Federal Reserve's July Monetary Report says a move in recent years toward tighter regulation may have lowered bond dealers' incentive to make markets, although it adds that it has not observed any significant decrease in liquidity.

Europe

BoE Paper on Resilience of Corporate Bond Markets and the Role of Investment Funds

On July 12, 2017, the Bank of England (BoE) published a paper titled "Simulating stress across the financial system: resilience of corporate bond markets and the role of investment funds". This paper examines the resilience of liquidity in European corporate bond markets by exploring the interaction between dealers and open-ended investment funds that participate in those markets. The paper highlights the "liquidity mismatch" between mutual funds, which offer instant redemption to investors, and the corporate-bond market, where many securities are difficult to trade, particularly during a credit event. The paper finds that potential firesales by investors could have a significantly negative impact on bond values and, in turn, on financial stability. It also addresses questions about the scale of redemptions that would be needed to overwhelm the capacity of dealers to absorb those sales, resulting in market dysfunction. The report says investor redemptions one-third higher than those observed during the crisis could be sufficient for this to happen — an unlikely, but not impossible, event.

The FCA Outlines the Future of LIBOR

In remarks delivered on July 27, 2017, Andrew Bailey, Chief Executive of the UK Financial Conduct Authority (FCA), examined the sustainability of the LIBOR benchmarks and the work that is being undertaken globally to reform the interest rate benchmark landscape. Bailey noted several concerns with the current LIBOR framework, notably the degradation of the panel banks submitting into LIBOR and the lack of active underlying markets supporting LIBOR. Bailey states work must therefore begin planning transition to alternative reference rates and indicates that panel bank have committed to support current LIBOR until end-2021, enabling a smooth transition to an alternative benchmark.

In April, the Risk Free Rate Working Group in the UK selected reformed SONIA as its proposed alternative benchmark. In June, the ARRC (Alternative Reference Rates Committee) in the United States announced its choice of a broad Treasuries repo rate as its preferred alternative. Both of these benchmarks have the benefit of being anchored in significantly more active markets than term LIBOR and rely on transaction data collected from all relevant market participants by the relevant central banks.

Asia Pacific

HKMA and SFC release conclusions on the OTC derivatives regulatory regime

The Hong Kong Monetary Authority (HKMA) and the Securities and Futures Commission (SFC) published conclusions on a joint consultation paper which proposed adjusting the scope of "OTC derivative product" under the over-the-counter (OTC) derivatives regulatory regime. The proposed adjustments were to:

- Prescribe certain additional markets and clearing houses so that products traded and cleared through them will not be regarded as "OTC derivative products"; and

- Exclude Delta One Warrants from the definition of "OTC derivative product".

After considering the feedback from market participants, the HKMA and SFC concluded that the proposed adjustments should be implemented. The conclusions paper also provides further clarification as to how Delta One Warrants will be defined. The HKMA and SFC will work with the Department of Justice on drafting the necessary legislative amendments to implement these changes.

Global

FSB Publishes Progress Reports on OTC Derivatives Reforms

The Financial Stability Board (FSB) has published three reports setting out progress on reforms to over-the-counter (OTC) derivatives markets. The reports find that:

- Implementation of the reforms is now well-progressed, although this has taken longer than originally intended due to the scale and complexity of the reforms and other challenges.
- Meaningful progress has been made toward mitigating systemic risk through central clearing and the higher collateral requirements in place to reduce counterparty credit risks within the system.
- Authorities also report progress in improving transparency through the use of data from trade repositories (TRs), and increased adoption of platform trading.
- Further study should be made of the effects of the reforms in protecting against market abuse. There is limited evidence on this at present, although some authorities report using TR data for market surveillance purposes.
- A range of views have been expressed on the impact of market reforms on spreads and liquidity in OTC derivatives markets.

While the reports publicize the significant progress made on the implementing global reforms and shine light on some areas of concerns, they are silent on other areas such as the negative impact stemming from the lack of rule harmonization.

Basel Committee Consults on Capital Treatment for STC Securitizations

On July 6, 2017, the Basel Committee on Banking Supervision released the consultative document Capital treatment for simple, transparent and comparable short-term securitisations. The Committee's proposed capital treatment supplements the consultative document Criteria for identifying simple, transparent and comparable short-term securitisations, issued jointly with the International Organization of Securities Commissions (IOSCO).

The consultative document sets out additional guidance and requirements for the purpose of applying preferential regulatory capital treatment for banks acting as investors in or as sponsors of simple, transparent and comparable (STC) short-term securitizations, typically in asset-backed commercial paper (ABCP) structures. The additional guidance and requirements include that:

- Investors have access to key monthly information on the performance and key characteristics of the ABCP structure;

- The redemption risk of the underlying assets is addressed from the sponsor's perspective; and
- The transactions funded by the conduit have an enforceable legal structure and that the relevant information is disclosed by the sponsor to investors.

G-20 Commitment to Basel III implementation

Leaders from the Group of 20 nations meeting in Hamburg, Germany, on July 7-8, 2017 reaffirmed their support for implementing Basel III banking rules. They indicate they will work to finalize the Basel III framework without further significantly increasing overall capital requirements across the banking sector, while promoting a level playing field. The leaders state they will continue to closely monitor and, if necessary, address emerging risks and vulnerabilities in the financial system. Leaders emphasized the considerable progress made towards transforming shadow banking into resilient market-based finance and welcome the FSB assessment of the monitoring and policy tools available to address risks from shadow banking. The Leaders also support the FSB's work to analyze the effects of financial regulatory reforms and the structured framework for post-implementation evaluation. The Basel Committee on Banking Supervision published a report for the G20 Leaders at their Summit meant to provide an update on the implementation of Basel III regulatory reforms since the Committee's last progress report to G20 Leaders in August, 2016.

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