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INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

From the Desk of Ian Russell
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IIAC Fixed Income Market Regulatory Update – March 31, 2016

Canada

Minutes from the Most Recent Bank of Canada Canadian Fixed-Income Forum (CFIF)

- Forum participants noted that increased volatility from global uncertainty contributed to relatively **weak demand for new bond issues at the start of 2016**. This volatility also affected secondary market trading.
- Participants referred to **reduced foreign interest in some provincial bonds**, and decreased demand for short-term assets that had been associated with total return swap transactions. It was noted, however, that **Canadian banks had taken advantage of strong international demand** to successfully issue new debt denominated in foreign currencies.
- Participants discussed the Canadian Securities Administrators (CSA)'s proposal to use the Market Trading Reporting System (**MTRS**) 2.0 to improve transparency in the Canadian corporate market. While some participants said there would be **benefits for retail participants**, others suggested that, because of the delay in publication of the data, the **impact on the functioning of the wholesale market would not be a significant**. A few participants thought there was a potential for **unintended consequences from the transparency initiative**, including a further decline in liquidity for more illiquid instruments. Some buy-side participants said that improved pre-trade transparency in the Government of Canada market would be beneficial for liquidity—it would **encourage active foreign investors to trade less-liquid non-benchmark bonds**.
- It was also noted that the current CSA transparency exemption for government bond trades expires in 2018, and that consideration will soon need to be given as to whether the exemption should be renewed.
- The Bank of Canada concluded that **since 2010**, (i) both corporate bond new issuance and trading volumes have increased, while average trade sizes have remained relatively unchanged in Canada; (ii) corporate bond trading is concentrated in a small number of issues; and (iii) trading of individual issues declines as a bond ages. In the U.S., trading volumes have increased while trade size and turnover decreased, likely a result of the increased electronification of markets, since participants generally traded smaller sizes on the platforms.

Ontario Securities Commission (OSC) Sets Out Priority Actions for 2016-2017

- One of the OSC's 2016-2017 goals is to **enhance oversight (improve access, transparency and fairness) of the fixed income secondary trading market**.
- The **OSC's next steps** are to implement public transparency of fixed income trading data, specifically for corporate debt, with IIROC acting as the information processor for corporate debt;

monitor fixed income trading data to assess the impact of transparency; and conduct a comprehensive review of dealers' allocation practices for new debt issues.

- **We note that there is no indication in the OSC Statement of Priorities that an effort will be made to undertake a cost-benefit analysis** of specific initiatives to improve debt transparency before implementation.
- The OSC's Statement of Priorities is available here. Individuals and organizations interested in making written submissions on the OSC's priorities can do so by May 9, 2016.

The Investment Industry Regulatory Organization of Canada (IIROC)'s 2016 Compliance Priorities

- On November 1, 2015, IIROC-regulated dealers that are Government Securities Distributors began reporting details of their fixed-income trades to IIROC via the new Market Trade Reporting System (MTRS 2.0). **Trading Conduct Compliance (TCC) staff is examining IIROC dealer member compliance with the reporting rule** as part of regular TCC reviews.
- The Debt Surveillance team (which performs routine surveillance and follows up on questionable trades) is also **conducting ad hoc reviews of reported transactions for completeness, accuracy and timeliness**.
- All other dealer members that conduct fixed-income trades will be required to report details of their transactions by no later than November 1, 2016. IIROC is working on the dealer interfaces necessary to facilitate those reports, and will be making further announcements during the year.
- **As of April 2016, the scope of TCC examinations will expand beyond the universe of IIROC dealer members** subject to market integrity-focused examinations to include non-participant dealer members that are active in either primary or secondary fixed-income securities trading, secondary trading of over-the-counter or foreign equity securities, or active in other asset classes including foreign exchange and derivatives.
- Additional information on the IIROC's compliance priorities is available here.

Report Backs Canada as Islamic Finance Hub

- A Thomson Reuters report commissioned by the Toronto Financial Services Alliance (TFSA) **advocates that Canada explore opportunities to create a hub for Islamic finance in Toronto** and position Toronto as a North American Islamic finance hub.
- The report says that **federal or provincial government issuance of a debut sovereign *sukuk* would act as a catalyze for the development of a viable market for infrastructure and corporate *sukuks*** (bonds).
- An increasingly common structure used for *sukuk*, the Islamic equivalent of conventional bonds, is an agency (*wakala*) structure where a special purpose vehicle (SPV) issues *sukuk* and uses it to purchase a pool of tangible or intangible assets. Whereas the *murabaha* transaction is not tradeable, a *wakala sukuk* is tradeable provided that no more than 49% of its assets are made up of intangible assets including *murabaha* receivables.
- Unlike a securitization, there remains recourse against the originator rather than solely against the assets sold to the SPV which provides investors with an asset-based, unsecured debt equivalent. This type of structure has been used by many issuers including the Islamic Development Bank, Hong Kong's sovereign sukuk, the World Bank's International Finance Corporation, and the International Islamic Liquidity Management Corporation (IILM).

- The UK government has taken an active role in promoting London's position in the Islamic finance industry and facilitating the necessary regulatory and tax changes that support its growth.
- The Thomson Reuters report is available here. You can read about the advantages of creating an Islamic finance hub in Canada, and the challenges and issues that will need to be addressed.

Europe

Brexit – Risk to Bonds and Fixed Income

- As the June 23, 2016 UK referendum on whether to leave the European Union draws near, the debate over Brexit intensifies. The Bank of England (see Financial Times, *Bank of England says Brexit carries risk of credit crunch*, March 29, 2016) stated that **Britain's EU referendum represents "the most significant near-term domestic risk to financial stability**".
- The Bank of England is taking steps to ensure commercial banks have significant capital to withstand major shocks to the financial system from a Brexit victory.
- The FT article notes "**the banks are being asked to clear a higher bar in this year's stress tests**, which model a deeper shock to the global economy than the past two exercises and for the first time formally include two extra capital buffers in the overall requirements for banks."
- The Bank of England has warned the **UK's high current account deficit left it vulnerable to a Brexit vote, which would trigger a rise in borrowing costs** for the government, businesses and households. It also added that borrowing costs could also rise in the Eurozone with a knock-on effect.
- The UK Treasury Select Committee has launched **a wide-ranging enquiry into the economic and financial costs and the benefits of the UK's EU membership**. Numerous financial executives have been called to testify before the Committee. Boris Johnson, Mayor of London, testified before the Treasury Select Committee on the economic and financial cost of the United Kingdom's membership in the European Union (EU) on March 22, 2016. Other executives that testified include Lord Rose, Chairman, Britain Stronger in Europe, and Will Straw, Executive Director, Britain Stronger in Europe; and Dr. Mark Carney, Governor, Bank of England, and Sir Jon Cunliffe, Deputy Governor, Financial Stability, Bank of England.

MiFID II – Back to the Drawing Board

- On March 17, 2016, the European Commission informed the European Parliament's MiFID II negotiating team that **draft regulatory technical standards on bond market transparency**, on the ancillary activity exemption and on position limits **were sent back to the European Securities and Markets Authority (ESMA) to revise** those standards taking into account the European Parliament's remarks.
- The European Parliament said the **latest drafts were just not up to standard**; however, the redrafting must not lead to further delaying the overall MiFID II timeline.
- The European Parliament is concerned that potentially too many illiquid instruments were inappropriately being classified as liquid.
- As a reminder, MiFID II broadens the pre- and post-trade transparency rules for bonds. ESMA adopted an instrument-by-instrument approach to assess liquidity on individual bonds. Each borrowing instrument is assessed against the following three criteria:
    - Is the average daily notional amount traded at least €100,000;

    - Does the bond trade at least twice a day, on average; and
    - Does the bond trade in at least 80% of the trading sessions available?
- If the answer to all of these questions is yes, then the bond is deemed liquid. The calculation is undertaken every three months.

IOSCO published the Securities Markets Risk Outlook 2016

- **The Outlook identifies and examines four potential risk areas. Corporate bond market liquidity is one area**.
- The report notes corporate bond issuance globally has been on an upward trend since 2011, reaching an all-time high of $3.5 trillion in 2014 before falling back to $3.3 trillion in 2015. The majority of issuances continue to be investment grade ($2.9 trillion in 2015) and high-yield issuances ($416 billion).
- With the expansion in corporate bond primary markets, **there is some concern whether the secondary market structure will be able to withstand periods of market stress**.
- **Traditional measures of secondary market liquidity present an inconsistent story**. On the one hand, the bond turnover ratio has decreased in U.S. and European secondary markets. Dealer inventories of corporate bonds also appear to be low and, in the U.S., appear to have recently entered negative territory.
- On the other hand, trading volume within U.S. secondary markets and certain other secondary markets has been growing over the last 5 years. In addition, bid-ask spreads have tightened since 2008.
- **Contradictions in the picture of secondary market liquidity may be attributable to abnormal market conditions and changing market structure**, i.e. away from a dealer-oriented principle-based model and towards an agency-based model.
- While dealer banks may be reducing their market-making role, it is not clear whether liquidity is in fact being critically affected. Non-primary dealer traders may be stepping in to provide liquidity. Also, the continued adoption of electronic trading and other alternative trading mechanisms may provide ways to bring together buyers and sellers.
- To read the full IOSCO Outlook, and to access data and charts, click here.

HM Treasury Director General Charles Roxburgh Delivered Keynote Speech at the 11th Annual Association for Financial Markets in Europe (AFME) Fixed income and FX Market Liquidity Conference in London (February 25)

- Mr. Roxburgh described the recent retrenchment of global banks from international markets, notably the U.S. and Europe.
- Mr. Roxburgh said **banks' holdings of trading assets in the U.S. and Europe decreased by more than 40% between 2008 and 2015. Dealer inventories of corporate bonds in the U.S. have fallen by 60% during the same period**. Transactions per unit of inventory stock for corporate securities now stands at 30, compared to just 6 during the financial crisis. Turnover in UK gilts is at its lowest point since 2005.
- He also said it can be argued that there were **abnormally high dealer inventories prior to the crisis**, which inflated the perception of endless liquidity. In many respects **what we have seen in recent years can be considered a necessary correction, although we are yet to ascertain whether the momentum has swung too much the other way**.

- He stressed there are **areas that give policymakers pause for thought and, perhaps, cause for concern, such as sudden and unexplained price volatility, fragmentation of liquidity, and reduction of capital employed in support of market-making**. He said some of this is just necessary rebalancing but it is a process that cannot continue indefinitely.
- The Bank of England's Financial Policy Committee (FPC) is closely monitoring potential systemic risks. While the FPC late last year looked at investment funds and concluded that the liquidity of the assets held would be sufficient to comfortably manage outflows under any known historic stress scenarios, it also acknowledged that these **funds could potentially contribute to systemic risk**, largely due to the mismatch between almost immediate redemption terms and the underlying liquidity of the assets.
- The HM Treasury is also very keen to understand the impact of new technologies.
- You can find out what the HM Treasury is doing in response to these concerns by clicking here.
- Materials from the AFME's conference is available here.

United States

U.S. Federal Reserve Governor Lael Brainard Provides an Update on Liquidity and Resilience

- In his remarks to the Institute of International Bankers Annual Washington Conference (March 7, 2016), Governor Brainard said **it does not appear that day-to-day liquidity has declined notably, but some characteristics of liquidity provision are changing**.
- **Bid-ask spreads generally remain in line with pre-crisis norms in most markets**. However, the declining size of trades in some markets suggest it may have become more expensive and more time consuming to implement large trades. There may be greater incidence of outsized intraday price movements.
- **Liquidity appears little changed in secondary markets** that have traditionally been highly liquid, such as Treasury bonds and highly rated corporate bonds. There has been **some reduction in liquidity in the markets that have historically been less liquid**.
- Anecdotal evidence suggests **market participants may be using relatively more liquid instruments to hedge exposures in other less liquid market segments**, perhaps unintentionally contributing to increased correlation across markets.
- Regulatory agencies in the U.S. and the Financial Stability Board (an international body that monitors and makes recommendations about the global financial system) have **work under way focusing on possible fire-sale risk associated with the growing share of less liquid bonds held in asset management portfolios** on behalf of investors who may be counting on same-day redemption when valuations fall.
- The Securities and Exchange Commission (SEC) has put proposals forward to ensure mutual funds have ample liquidity buffers under stressed scenarios and measures to address the risk of heavy redemptions and fire sales. U.S. Federal Reserve surveillance will continue to undertake more granular analysis of liquidity resilience and associated risks.
- Finally, Governor Brainard said it is **difficult to disentangle the effects on liquidity of changes in technology, market structure and broker-dealer risk-management practices** in the wake of the crisis on one hand, and regulation on the other.
- You can read Governor Brainard's speech by clicking here.

The Financial Industry Regulatory Authority (FINRA) Delays Implementation Date of Rule 2242 (Debt Research Analysts and Debt Research Reports)

- **FINRA delayed the implementation of Rule 2242, which addresses conflicts of interest relating to the publication and distribution of debt research reports, until April 22, 2016**. The rule was originally scheduled to become effective on February 22, 2016. The delay will allow member firms additional time to implement changes to their policies and procedures.
- Rule 2242 **outlines the prohibited and permissible communications between debt research analysts and personals outside the research department**, including principal trading and sales and trading personnel.
- There are **exemptions for debt research reports provided to institutional investors**—they are not subject to all of the independence and disclosure standards applicable to debt research reports prepared for retail investors.
- Rule 2242 provides an **exemption from certain requirements of the rule for certain firms with only limited investment banking activities**. It also provides a similar exemption for firms with limited principal trading activity.
- Additional information, including the definition of "debt research reports" is available here.

Asia

China Further Opens Interbank Bond Market

- In early March, **the People's Bank of China (PBC) expanded the pool of eligible foreign investors in the interbank market**. They now include almost all foreign commercial banks, insurance companies, securities firms, asset management companies and long-term investors such as pension funds, charity funds and endowment funds.
- Securities firms and asset managers are limited to those participating in the Qualified Foreign Institutional Investor (QFII) and Renminbi Qualified Foreign Institutional Investor (RQFII) programs.
- The **only criteria that institutions now have to satisfy** is that they have been established in accordance with relevant local laws; they have sound management structures, internal control systems and standard business practices; their funds are legally sourced, and they are able to identify, understand, manage and bear the risk of owning bonds.

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. Click here to read the Highlights of Our 2015 Achievements.

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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