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

FILLING THE GAP

Perspectives on Transparency for Canada's Government Debt Markets

MARCH 2018

PREFACE

On January 1, 2018, the long-standing exemption to Canada's transparency requirements for government debt securities expired. Rather than continue to rely on market forces to drive the level of transparency delivered to investors, the Canadian Securities Administrators (CSA) will soon mandate a transparency framework for government debt markets.[1] We believe their decision is not based on any discernible deterioration in the quality of Canadian government debt markets since the exemption was first introduced over 15 years ago, but rather the increased focus regulators globally have placed on making markets more transparent. The framework ultimately adopted could impact the functioning of this vital market.

What is the right transparency approach for Canada? This paper outlines various considerations that must not be ignored when developing Canada's framework. It looks at what forces have been contributing to debt transparency in Canada, and examines transparency regimes in other jurisdictions to see what insights they provide. It concludes by identifying which market participants would benefit most from mandated public transparency of Canadian government debt markets, and recommends a framework to meet their needs without impairing overall market functioning.

BACKGROUND

In 2001, the CSA established the regulatory framework for transparency in the fixed income markets through implementation of National Instrument 21-101 and Companion Policy 21-101CP. These regulations applied to the trading of corporate debt securities, but exempted for a period the transparency requirements for government debt securities so that market participants could be further consulted on the optimal level of transparency for this market. Since then, the CSA elected on multiple occasions to further extend the exemption noting that no other jurisdiction mandated transparency requirements for government debt securities and that additional time would allow international and domestic regulatory and industry developments to be considered in determining what, if any, mandatory requirements are needed.

With Canadian regulators recently completing their more pressing transparency overhaul for corporate debt markets, and the most recent exemption for government debt expiring at a time when Europe is introducing its expansive new transparency regime, the CSA has announced it will mandate transparency for government debt markets. The requirements are likely to be determined in 2018.

THE TRANSPARENCY CONUNDRUM

Financial markets require a level of transparency to function efficiently and effectively. Market participants cannot make knowledgeable investing decisions without some information about the products or markets they transact. Transparency contributes to the price discovery process, fosters investor confidence and, thereby, encourages participation in the market which enhances market liquidity. Increased transparency can also combat concerns over information asymmetry in the market— that is, reducing opportunities for less-informed market participants to be taken advantage of by more sophisticated investors. Specific to fixed-income markets, transparency most commonly refers to the availability of information related to pre-trade quotes (i.e. bid and offer prices and sizes) and the post-trade reporting of transacted prices and volumes. Pre-trade transparency, therefore, makes available information pertaining to where trades can be executed whereas post-trade transparency makes available information surrounding trades that have already taken place.

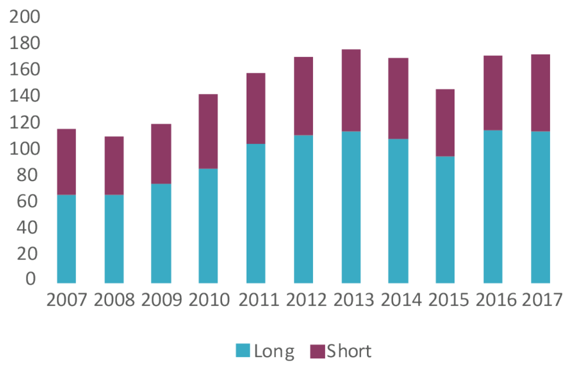
While the benefits from market transparency are widely understood, policy makers are also very much aware that for fixed income markets, there exists a tipping point beyond which the benefits from incremental transparency can be

[1] See CSA Staff Notice 21-320

outweighed by adverse implications on market liquidity, thereby damaging overall market quality.

To understand this dichotomy, we need to recognize that despite its recent electronification, Canadian bond markets continue to be largely dealer dependent over-the-counter markets. Dealers act as essential intermediaries providing immediate liquidity to the market by executing orders for their own inventory or by trading as principals. Not only do these inventories require a significant capital commitment from the dealers, but expose them to substantial risks resulting from potential adverse market movements or degradation in the credit quality of their portfolio. Dealers manage this risk by adjusting their exposures in the inter-dealer market.

Canadian Dealer Inventory – Debt Securities
$ CAD Billions



Source: IIROC

The long-held industry concern has been that if full trade details, such as size and price, are released too quickly (i.e. full post-trade transparency) it could reveal positioning in the market impairing the anonymity of the transacting parties, while also jeopardizes the dealers' ability to manage positions in the inter-dealer market. To compensate for this risk, dealers would widen their bid/offer spreads or choose to limit the amount of liquidity they provide (i.e. retreat from the market or cut clients) or simply transition to a pure agency model (i.e. no longer take bonds into inventory). A shift toward agency trading would represent a change in the structure of Canadian bond markets and could worsen some aspects of market liquidity.[2]

Finding the "optimal" level of market transparency, therefore, requires a delicate balance whereby measures taken to increase transparency also consider the implications those measures could have on the liquidity dealers are willing to provide. While this balance is generally most precarious for more thinly traded markets, such as that for high-yield corporate bonds, it cannot be ignored when developing a transparency framework for government debt markets.

To attempt to address this conundrum, policy makers have traditionally relied on calibrations, such as time delays or volume caps, in their transparency frameworks. The extent of the calibrations has generally been a function of the underlying liquidity of the asset class covered by the transparency regime.

INTERNATIONAL APPROACHES TO GOVERNMENT DEBT MARKET TRANSPARENCY

Canadian regulators are also aware of the approaches other jurisdictions have taken regarding debt market transparency. A look beyond our border may provide some insights for Canada. The United States and Europe, representing the two deepest and most developed fixed-income markets in the world, may serve as the logical yard-sticks.

EUROPE

In January 2018, Europe implemented comprehensive new pre-trade and post-trade transparency requirements in respect of bonds (and other products)[3] - sovereign and government debt included. Europe's transparency regime is meant to establish a level playing field between trading venues so that the price discovery process of a financial instrument is not impaired by the fragmentation of liquidity that currently exists in Europe. Investors, therefore, will be informed of actual or potential trade information irrespective of whether the transactions occur on Regulated Markets, Multi-lateral Trading facilities, Systemic Internalisers, Organized Trading Facilities or elsewhere.

With respect to Europe's pre-trade transparency requirements, market operators and trading venues will make public the range of bid and offer prices and the depth of trading interest at those prices, in accordance with the type of trading system they operate. For Request-for-Quote (RFQ) systems, this implies making public all the quotes received.

Regarding post-trade transparency, trading venues and investment firms trading outside of a trading venue are required to make transaction details public as close to real time as technically possible and, in any case, within 15 minutes of trade execution (eventually dropping to within 5 minutes). Trade details published include price, notional value, venue of execution, trade date and time.

Europe's transparency requirements, however, are subject to a complicated mix of various conditions and waivers aimed to avoid unintended consequences, namely impairing market liquidity. Notably, publication of information can be waived or deferred for orders/transactions which are 'Large in Scale' compared to normal market size, are above a 'Size Specific to a Financial Instrument' or pertains to bonds for which there is not a liquid market. Interestingly, of the approximate 69,000 bonds analyzed by the European

[2] Bank of Canada Staff Analytical Note 2017-11 titled "Do Canadian Broker-Dealers Act as Agents or Principals in Bond Trading?"

[3] See Commission Delegated Regulation (CDR) 2017/583 (RTS2)

Securities Market Authority (ESMA) barely 800 were determined to have a liquid market.[4]

THE UNITED STATES

Since 2002, the mandated transparency framework in the U.S. has centered around the Financial Industry Regulatory Authority's (FINRA) Trade Reporting and Compliance Engine (TRACE). The system largely captures and disseminates consolidated post-trade information on secondary market transactions conducted by FINRA members in publicly traded TRACE-eligible corporate debt securities.

Analysis of the effects of TRACE on U.S. corporate bond market functioning has delivered varied conclusions. One of the most comprehensive of the quantitative TRACE studies finds that while mandated transparency of U.S. corporate debt markets may benefit some market participants through a decline in price spreads, it harms others through a reduction in trading activity.[5]

TRACE has expanded in recent years beyond corporate debt securities to capture and publish post-trade information on agency debt securities, mortgage-backed securities, asset-backed securities and other securitized products. Most recently, as of July 10, 2017 FINRA Members have been required to report into TRACE transactions in marketable U.S. Treasury securities, including Treasury bills, notes, bonds and inflation-protected securities ("TIPS"). Generally, trades in eligible Treasury securities are required to be reported by the FINRA member on the day they are executed. Reportable transaction information includes: size (volume), price, buy/sell indicator, date, time, principal/agent indicator, commission, etc. It is important to note, however, that FINRA does not currently make this information public. As it relates to treasuries, therefore, TRACE is being utilized by U.S. regulators solely as a data gathering tool and not a market transparency vehicle.

To summarize, while European and American debt markets are largely viewed among the most liquid and efficient, their approaches to debt market transparency drastically differ. Europe has opted to mandate full pre-and post-trade transparency across all its regulated markets, venues and investment firms and for essentially all debt products traded in the EU including government debt (though only a small subset of bonds currently deemed liquid enough to qualify for full capture). The U.S., on the other hand, has opted to remain focused on post-trade transparency directed at FINRA regulated investment dealers, recently expanding beyond corporate debt securities but falling short of mandating public transparency on its treasuries market.

A look beyond Europe and the U.S. would reveal further disparity in the government debt transparency approaches taken by various other jurisdictions. The lack of international consensus should provide impetus for Canadian authorities to develop an approach tailored specifically for the Canadian market.

CONSIDERATIONS FOR CANADIAN POLICY MAKERS

While it is helpful to be aware of the transparency approaches being taken elsewhere, things such market size, investor and issuer composition, penetration of electronic trading, etc. can vary across jurisdictions, yet all play an important role in determining the information needs of the market. Furthermore, what may be viewed as an appropriate level of transparency in one jurisdiction may be less than optimal in another.

Below are several considerations when developing Canada's approach to mandated transparency of government debt markets.

1. MARKET AND DEALER INITIATIVES CONTRIBUTE TO DEBT MARKET TRANSPARENCY

The contributions of market led solutions to expanding government debt transparency in Canada must be acknowledged. CanPX,[6] a joint initiative between Canadian investment dealers and inter-dealer brokers, has been voluntarily providing pre-trade and post-trade transparency on a comprehensive universe of government debt securities for over fifteen years. Through CanPX, subscribers, including institutional investors and government issuers, are provided a consolidated view of real-time pricing from within Canada's inter-dealer bond market. More recently, other market data providers have also created or ramped up offerings for their Canadian fixed income clients. These products provide subscribers with differing combinations of pre-trade and post-trade information on-demand in easily digestible formats.

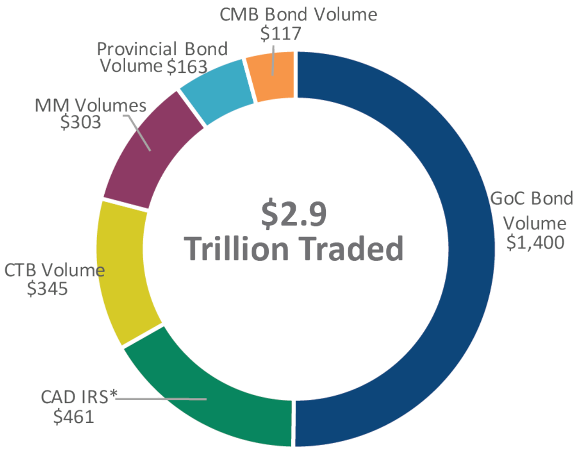
Additionally, electronic trading platforms continue to take hold in Canadian debt markets and we should be cognisant of their contributions to market transparency. The RFQ protocol commonly adopted by these platforms provide institutional investors real-time access to executable multi-dealer prices. These platforms also continue to innovate and bring increased efficiencies and transparency to the market. For example, CanDeal's 'List Trading' service allows investors to query up to four dealers simultaneously with lists of up to 30 securities, eliminating the need for a series of RFQs. The "due in" protocol of the service promotes orderly price responses from the dealers and trade details are automatically sent via straight-through processing (STP), promoting end-to-end workflow efficiencies.

[4]See ESMA Transparency Calculation Notice, January 2018

[5]See "The Effects of Mandatory Transparency in Financial Market Design: Evidence from the Corporate Bond Market" (Asquith, Covert and Pathak, 2013)

[6]The Investment Industry Association of Canada ("IIAC") serves as corporate secretary for CanPX

Electronic Trading on CanDeal (2017)
$ CAD Billions



Source: CanDeal
*CanDeal/Tradeweb North American IRS Platform

Investment dealers also continue to facilitate price discovery for their clients. In addition to supporting various electronic trading platforms and feeding their prices into market data services, including various bond indexes, dealers also have countless bilateral discussions with their institutional clients to apprise them of market conditions and prices at which they can transact.

The net effect from all the above is reflected in a 2016 survey of market participants conducted by the Canadian Fixed Income Forum (CFIF) which revealed that the level of pre-trade transparency in Canadian debt products is perceived as generally good for most government debt.[7]

This conclusion is explained by the fact that, in the absence of a mandated transparency solution, Canadian institutional market participants have been successful in finding other avenues for fulfilling their information needs. Similar choices are present in many parts of the world and may be another factor why jurisdictions have been hesitant to mandate transparency for their government debt markets, with Europe the notable exception.

2. THE EFFECTS OF OTHER CANADIAN REGULATORY INITIATIVES

The increased focus in recent years on fixed income markets by Canadian overseers has resulted in several regulatory initiatives to ensure investors obtain fair execution prices in the marketplace and which contribute to the transparency agenda.

Canadian investment dealers registered with the Investment Industry Regulatory Organization of Canada (IIROC) are required to obtain bond prices for customers that are fair and reasonable in relation to prevailing market conditions.[8] To ensure compliance with this requirement, IIROC introduced a debt surveillance system in 2015 that now captures, on a post-trade basis, all over-the-counter debt market transactions executed by its Dealer Members, including government debt securities. IIROC's collection of government bond trade details came into effect approximately 19 months before FINRA commenced the collection of transaction information on U.S. Treasury securities from its members via TRACE. IIROC uses the trade reporting it receives to identify potential market abuses, including violations of the Dealer's fair pricing requirements. Canadian investors, large and small, should, therefore, have some comfort in the prices obtained, irrespective of what form the public debt transparency system takes. Additionally, Canada's recently implemented Client Relationship Model (CRM 2) requires additional disclosures made to retail investors so that they better understand the cost and performance of their fixed income positions.

Consequently, we view the Canadian regulatory framework for debt markets to be among the most comprehensive and, that too, should have a bearing into the transparency framework implemented.

3. RECOGNIZING THE CURRENT GAP

While the public transparency framework ultimately implemented should benefit the market broadly, it should center on fixed income market participants that currently lack sufficient information for transacting in our government debt markets.

As illustrated, there is significant information available to most institutional investors dealing in Canadian government debt securities stemming from their growing preference to transact electronically. Moreover, these participants continue to access comprehensive price information by subscribing to private sector data offerings or contacting dealers directly.

Similarly, government debt issuers also have good visibility on the bid-offer quotes and trade prices of debt instruments, including their own. They achieve this through use of the various market data services available as well as through regular dialogue with the dealer syndicates that help bring their issues to market.

Canadian regulators are also unlikely to seek out information from a public transparency system for carrying out their market oversight given their current access to more detailed debt market data via IIROC's debt surveillance system.

Lastly, we turn to the retail investor. While the trend towards the use of Mutual Funds and Exchange Traded Funds for accessing debt markets has resulted in changes to their information needs, retail investors generally continue to have more limited and less timely access to price information

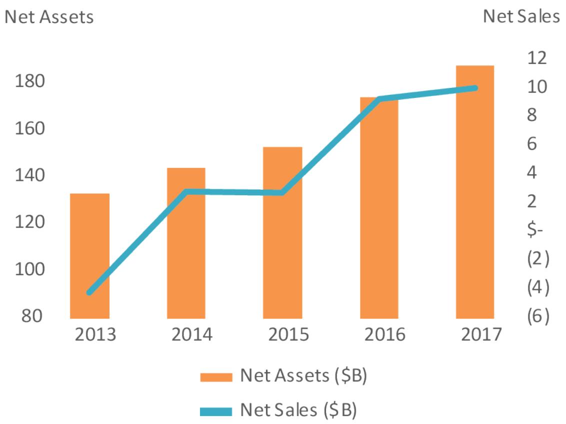
[7] See CFIF Survey

[8] IIROC Rule 3300.7 Fair Pricing of Over-the-counter Securities

compared to other market participants.

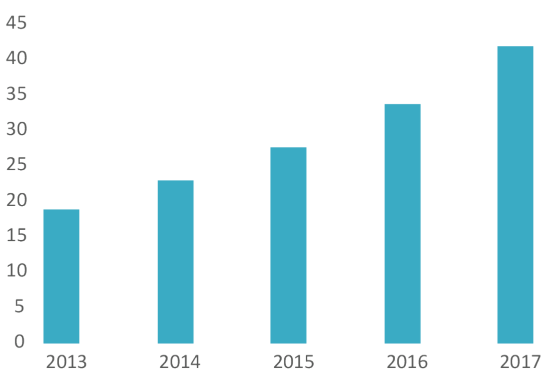
A shortcoming for Canadian retail investors has been the lack of available sources providing timely bond information that is freely and easily accessible.[9] Most of the private sector transparency solutions, including CanPX, have been centered around the needs of the institutional investors. While regulatory measures have been implemented to ensure retail investors are obtaining fair market prices on their transactions, additional sources of information may assist them in verifying or questioning the prices they obtain. Greater transparency might also encourage increased levels of retail participation in our debt markets.

Bond Mutual Funds - Net Assets and Sales
$ CAD Billions



* Assets as at December 31st
Source: Investment Funds Institute of Canada (IFIC)

AUM Canadian Fixed-Income ETFs
$ CAD Billions



As at December 31st
Source: Canadian ETF Association, Strategic Insight

A RECOMMENDED FRAMEWORK FOR GOVERNMENT DEBT TRANSPARENCY IN CANADA

The focus for regulators should be on deciding where to place the fulcrum of mandated transparency by addressing current gaps. In our view, a mandated public transparency framework for Canadian government debt markets would be of greatest value to retail investors and should be designed with their needs primarily in mind and without imposing administrative burdens and added costs to market participants.

HOW TO PROCEED

Fortunately, the two main building blocks we see for making retail investors more informed about their fixed income investing decisions are already largely in place.

Through IIROC's debt surveillance system Canada has a central repository for all retail (and institutional) fixed income transactions executed through Canadian investment dealers, including price, date, yield, commission/mark-up etc. This trade repository will most likely underpin the government debt transparency solution ultimately developed by Canadian regulators, much like for the corporate debt transparency solution launched in 2016. Leveraging IIROC's debt surveillance system for this added use is sensible provided what is required of its data contributors remains unchanged. The challenge rests with identifying what information to extract from the debt surveillance system while remaining respectful of the transparency conundrum.

For retail investors, typically executing small transactions in liquid bonds, we believe post-trade prices, made available with a timeliness or frequency calibrated to the liquidity of the asset class, may be a suitable approach. For example, traded prices for on-the-run government of Canada benchmark bonds, generally representing the most liquid security type, can be made available sooner or more frequent than less liquid classes of government bonds. In lieu of volume information, published prices should simply be identified as a "retail" or "institutional" so users have the context necessary for evaluating their obtained execution against prices displayed. Like the current transparency service for corporate debt markets, the mandated government debt transparency solution should provide investors with free and easy access to the information. Of critical importance, however, is ensuring awareness of the service among retail investors so that it is utilized in decision making.

Secondly, Canada's recently implemented Client Relationship Model (CRM 2) now brings retail investors a better understanding of the cost and performance of their fixed income positions. Specifically, yield is now disclosed on bond purchases and fixed income investors

[9] In 2016 IIROC launched its Public Corporate Debt Trade Reporting Service which provides free on-line access to corporate bond trade information collected by IIROC.

also receive information regarding the total amount of any mark-ups, mark-downs, commissions or other service charges they paid on their bond transaction. Furthermore, CRM 2 also requires Canadian registered firms to deliver investment performance reports to their clients showing total percentage returns for clients' accounts to provide investors information that would help them assess how their bond holdings performed over the period. The CSA should be commended for bringing cost and performance information to retail bond investors, however, as a next step they must evaluate how the CRM 2 measures are contributing to bond investors' decision making and whether any supplemental information is warranted.

CLOSING

Canada's market for government debt securities is one to envy. Its proven resiliency, efficiency and dependability have attracted countless investors and borrowers seeking to fulfill their mandates. For most Canadian market participants, the absence of mandated transparency has not curtailed the availability of the information required to transact confidently. With the information needs of institutional investors, government issuers and Canadian regulators largely met, Canada's mandated government debt transparency framework should focus on bringing useful and timely information to retail investors. Moreover, the information must be easily accessible and digestible without imposing significant burdens on those mandated to deliver the information and without compromising the high-quality functioning exhibited by Canada's government debt markets.