Is e-trading an ace in the hole for markets?

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Canadian regulators may wish to proceed cautiously when introducing tougher reporting standards for debt and derivatives markets. While greater transparency is a worthy objective, excessive intervention could threaten liquidity and open the way to equity-style rules being imposed on a successful institutional over-the-counter (OTC) marketplace. Electronic trading could provide an elegant way to diffuse what has become a simmering tension between market participants, as it delivers the oversight Canadian regulators seek, while preserving the proven benefits of the OTC ecosystem.

The accurate profile and demographics of the Canadian debt markets have long been masked by a reporting system that is more than a decade old, and provides little intelligence or real insight. The somewhat obscure categorization of trading activity does not, for example provide a clear break-out of overall trading volumes, and the distribution of the broadest information is only to a closed group of market participants.

Global regulation and the increased use of technology have led to more transparent trading and reporting rules in many jurisdictions, and there is no reason why Canadian markets should be any different.

Similar to other countries, there should be enough visibility in the Canadian marketplace to ensure fair, but not necessarily equivalent, pricing for both retail and institutional customers. However, as regulators finalize rules, it is imperative they recognize that debt and derivatives markets are institutional in nature and that excessive price and trade transparency may hamper effective market-making ability, resulting in unintended negative consequences for investors and dealers.

Transparency is multi-dimensional, and there is a clear difference between "price transparency", which is generally viewed as contributing to market efficiency, and "trade transparency" that can introduce new sources of market risk to both buyers and sellers. As regulators seek to enact change, they must balance their transparency objectives with the needs of market participants, respecting the unique properties and characteristics of each market and its participants.

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An "optimally transparent" solution will facilitate price discovery, but should not compromise an investor's ability to successfully execute a trade strategy, or obstruct liquidity providers looking to prudently manage their risk. Interestingly, the knock-on effect of excessive transparency can ultimately also harm the retail investor to the extent that institutional investors act as fiduciaries for their benefit - through for example third-party asset management, pension plans and insurance.

Aside from the concern that premature or excessive trade disclosure could harm liquidity, there is a danger that the new rules might also serve as a smokescreen to introduce a U.S.-style bond tape. Regulators in Canada are looking to the U.S. system, the Trade Reporting and Compliance Engine (TRACE), as well as reporting systems in Italy as models. As the Canadian market has a lower level of liquidity and is smaller than that of the U.S., and is not retail-dominated like the Italian market, these apples-to-oranges comparisons aren't ideal.

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increase in the availability of real-time pricing,.The majority of institutional investors in Canada regularly trade electronically, contributing to a 40% increase in trading volumes on CanDeal in Q2 2013 compared to a year earlier. In addition to the transparency and efficiency benefits e-trading has delivered to retail and institutional customers, it is enhancing legal compliance and already providing a valuable tool for regulators.

There is today a real opportunity for the blueprint for Canadian OTC debt markets to be re-drawn in a way that migrates trading to auditable electronic platforms, building off progress to date and providing regulators with the benefit of intelligent, evidence-based observations without being overly prescriptive or intrusive. Once the initial outline has been put in place, regulators would immediately gain from the inherent real-time data that is captured from e-trading, and could then enhance the rules over time to reflect empirical observations.

In summary, Canadian regulators appear to be seeking a solution for a problem that has already been solved. After all, the premise behind electronic trading is to provide a greater degree of transparency and audit trails for all market participants. Ultimately, more electronic trading of OTC markets will deliver a richer solution for all concerned, including the need for more fulsome regulatory oversight. And so while the ante has increased, encouraging – or even mandating -- electronic trading might just be the way to ensure that the current head-to-head plays out without either the industry or regulators having to go all-in.