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CANDEAL
WHERE THE MARKET COMES TO TRADE

OTC Derivatives Reform:
A Discussion of OTC markets in the Canadian Context

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As Canadian regulators strive to meet G20 regulatory reform commitments, pertaining to the derivatives markets, considerations regarding the uniqueness of the Canadian marketplace and avoiding a cut and paste of foreign rules are up for debate. Equally important, is acknowledging the distinct characteristics of the financial OTC derivatives markets versus exchange traded models, and the fact that OTC markets are largely institutional in terms of size and participants. In this paper, we discuss some key elements of the OTC ecosystem; why they exist and why they should be preserved. We also examine some important changes that have occurred in the OTC debt space over the past decade; their positive impact on the market and how they are relevant to reform considerations for the OTC derivatives space.

CanDeal continues to monitor the rule-making process that is unfolding in the United States, with regard to regulation of Over-The-Counter (OTC) derivatives. We are supportive of G20 goals related to the mitigation of systemic risk and the reform of OTC derivative markets; however, we note that proposed U.S. reforms are unnecessarily prescriptive in terms of liquidity protocols and boundaries. We encourage Canadian legislators and regulators to maintain focus on the primary objectives - registration, electronic trading, reporting, standardization and central clearing.

There is significant experience, proven methods and precedent in the evolution of OTC bond markets that can be studied in developing a suitable Canadian regulatory environment for our OTC derivatives markets. Regulators can be proud of the increased transparency, efficiency and risk-reduction that have accompanied the evolution of the OTC debt marketplace offered by CanDeal, and the fact that Canada is viewed globally as offering progressive market environments. We are confident that the guiding principles that have allowed us to evolve Canadian-dollar debt marketplaces will allow us to effectively implement OTC derivatives regulation as it develops in Canada.

Market Characteristics and Structure

The OTC debt and derivative markets have evolved organically in developing trade protocols and transparency solutions that are working and that should be respected. These market-evolved solutions meet the needs of institutional investors while providing participants with choices and the transparency that they require.

It is no accident that these OTC debt and derivatives markets have evolved the solutions they did, or that they operate so differently from exchanges that employ a central-limit-order-book. OTC markets are characterized by a large universe of bespoke instruments. Trade sizes are unique, and can be very large in economic value and risk exposure, with non-standard start dates and maturities. These instruments are traded by a relatively small constituency of investing institutions. Market movement is highly correlated to the direction of interest rates and events in the market, which can leave most market participants trading in the same direction at the same time. In concert, these conditions and market characteristics necessitate that a third-party "liquidity provider" stand in and take the other side of investors' trades, to ensure continuity of liquidity and efficient market operation. Attempts have been made in the bond market to electronically match institutional orders without any liquidity-provider involvement, but the results proved unacceptable to institutional investors that require timely and certain execution - only 5 to 8 percent of orders were matched in a given trading session.[1] Consequently, market participants have gravitated toward the Request for Quote (RFQ) trade protocol to meet their price discovery and transparency needs.

Investors require flexibility and discretion in the price discovery process and the manner in which they manage their sources of liquidity. They need access to reliable price information and an independent electronic trade record to drive the multiple processes associated with the life-cycle of a trade, including; portfolio construction, price discovery, trade execution, trade affirmation, trade confirmation, custodial instructions, trade settlement, post-trade analysis, risk management, and compliance oversight.

Canadian Primary Dealers provide many valuable services to their clients. Most significantly, they provide liquidity on demand. In taking the other side of their client's trade, dealers place their capital at risk and concede financial surpluses[2] that we estimate are in excess of $200 million annually. For trades executed on CanDeal in 2011, we can confirm that these surpluses exceeded $80 million.

Request For Quote

The RFQ trade protocol is proven to meet four criteria deemed essential by the buy-side. First, it provides liquidity on demand for the full size of the trade, which is required to meet obligations for best price, timeliness, and certainty of execution. Second, it allows the portfolio manager flexibility and discretion in defining the terms-of-trade and the manner in which liquidity is accessed. Third, it affords a level of simultaneous price discovery and price comparability that may otherwise not be possible.[3] Finally, it provides a winning margin that can be captured as a financial gain. Separately, the RFQ protocol provides CanDeal participants with an independent electronic trade record that is sufficiently detailed to accurately recreate events and place them in the context of the then-prevailing market; one that is permanent, accessible, and portable - delivered using industry-standard financial messaging protocols.

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The RFQ trade protocol has been embraced by institutional investors in OTC debt capital markets, globally. As evidence of its adoption by domestic and foreign institutions that invest in Canadian dollar denominated debt securities, CanDeal has experienced compound annual growth of 52% for the past 8 years.[4] The suitability of this trade protocol has prompted institutions to trade more value on CanDeal than is traded on the Toronto Stock Exchange, in every month since September, 2011[5].

CanDeal's RFQ trade protocol is analogous to, but much faster than, the RFQ/RFP process that is used by many governments, agencies and large corporations; when, as a customer, they procure goods and services from vendors. The RFQ/RFP is put out for tender to multiple qualified vendors. Each vendor responds with a firm sealed-bid, based on the terms specified by the customer. The contract is most often awarded to the best-priced vendor

1 Securities Technology Monitor – Interview Rick McVey, CEO, MarketAxess; April 13, 2012

2 The RFQ trade protocol requires the winning dealer to concede a surplus by paying a higher price than any of the competing dealers. This is similar to the financial surplus a home-seller realizes if they receive multiple offers to purchase their house. Example: In competition, on the sale of $10mln bonds, an investor accepts Dealer A's bid of $100.050 (Dealer B bid $100.021, C $100.010, D $99.999) – in setting a price of $100.050, Dealer A has paid $2900 more than was needed to win – to the benefit of their client.

3 Price discovery is best achieved simultaneously, in a discrete dealing environment that restricts opportunities for gamesmanship and compels market makers to show their best price first.

4 In calendar year 2011, CanDeal facilitated 172,000 institutional trades totaling C$1.5 trillion.

5 The Globe and Mail; March 27, 2012, online edition Boyd Erman

after considering all factors, including; price, timeliness, certainty of execution, and total expected cost. Information regarding the winning contract is provided solely at the discretion of the customer. Additionally, and similar to customer behavior on CanDeal, a process of qualification exists before a vendor is included in an RFQ. Qualification can be formal (as in a Vendor of Record), or subjective based on the vendor's specialty and/or expected ability to deliver the highest quality result. This RFQ process provides customers with a high level of price discovery, optimal transparency, and accountability in ensuring that dollars are spent efficiently while protecting the privacy and competitive interests of the vendors.

In OTC debt and derivative markets, the RFQ process differs in one important way from the general procurement of goods and services described above – that being the liquidity provided by investment dealers in their role as a "market maker."

By comparison, even within the exchange-traded market framework there is accommodation made for OTC trading. Recognizing that in certain instances, when the value of a trade is large in the context of available liquidity, there are pre-trade discussions that need to occur away from the exchange to mitigate volatility or disruptions to normal market operations. There is no mandated market canvas for how these discussions occur "upstairs". Other issues that are common to both exchange-traded markets and OTC derivative markets are "market integration" and the "fragmentation of liquidity."

Regarding fragmentation of liquidity, in OTC markets each liquidity provider can be considered a separate market – in Canada alone, there are 12 Primary Dealers[6]. CanDeal has addressed this issue by bringing all 12 Primary Dealers together in a single OTC debt marketplace.

On the subject of market integration, the RFQ trade protocol achieves market integration in a way that an investor using the telephone cannot, and it also creates a timely, accurate and reliable feedback loop. Further, the RFQ allows flexibility in accommodating the unique liquidity-management needs of each investor. It allows each institution, at their discretion, to select a number of market makers and simultaneously query them for firm dealing prices; then in real-time, it produces an electronic record of the transaction that contains quantified data that can be used for a comprehensive analysis. Transaction analysis, when combined with market intelligence related to dealer positions, abilities, and/or trading biases, is used to optimize investors' decisions.

The RFQ trade protocol provides the purest form of price discovery and price transparency. The price set by a liquidity provider can be a function of many variables, including; instrument, trade size, client relationship, number of competitors, dealer position, balance sheet, cost of funds, credit exposure, trader's bias, liquidity environment, market volatility, ability to lay-off risk etc. – while the market environment is common for all dealers, an individual market-makers' complex can differ significantly. Consequently, true price discovery is best achieved by obtaining firm prices from suited, trusted and proven liquidity providers, simultaneously, in response to identical terms-of-trade set by the client.

>> The RFQ allows flexibility in accommodating the unique liquidity-management needs of each investor.

The RFQ trade protocol addresses many of the issues associated with information asymmetries by allowing simultaneous competition between multiple dealers, which effectively eliminate any informational advantage or leverage a single dealer may have over their client. At one time, dealers may have had proprietary knowledge and competitive advantage over their institutional clients; this has changed for those involved in electronic RFQ trading. The convenience and effectiveness of the RFQ trade mechanism increases the number of dealers included in the price discovery process. This has dramatically increased the volume of trade-flow information present in the market and reduced the informational advantage of any single participant.

6 The classification of "Primary Dealer" applies to a sub-group of government securities distributors whose activity is above a certain threshold. The primary dealer designation can be attained for either treasury bills or bonds, or both and comes with commensurate responsibilities. As a group, these dealers represent the primary source of secondary market liquidity in the Canadian debt capital markets.

The Canadian OTC debt and derivative markets are small and diverse. The diversity of both the instruments traded and their terms-of-trade may minimize the benefits of post-trade transparency, while the relatively small market size may increase the risks to both institutional investors trying to execute a strategy and the dealers that assume their clients' risk.

Transparency

Reforming transparency in the financial ecosystem must balance regulatory objectives with the needs of market participants, respecting the unique properties and characteristics of each market and market segment in determining the appropriate form and implementation schedule.

CanDeal favours an "optimally-transparent" solution for OTC markets; one that facilitates effective and discrete price discovery, but that does not compromise the ability of investors to successfully execute a trade strategy, or liquidity providers to manage their risk - by publishing indications-of-interest on a pre-trade basis, exposing counterparties to a trade, or indiscriminately disseminating trade information.

CanDeal makes a demarcation 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 parties.

CanDeal advocates an incremental approach to transparency regulation – one that paints the broad strokes, respecting inherent market structure and fundamentals, then, works with the industry to evolve an optimal solution. However, CanDeal respects the need for regulators to have access to non-public trade records for the purposes of market oversight and enforcement.

>> Reforming transparency in the financial ecosystem must balance regulatory objectives with the needs of market participants

Regulated change to transparency in the OTC debt and derivative markets is complex and impactful on the operation of financial ecosystems, for better and for worse. This subject was explored in detail by the Investment Dealers Association of Canada (IDA), the Canadian Securities Administrators (CSA), the Bank of Canada and the Department of Finance when the ATS rules were first defined, beginning about 1999. In 2002, Deloitte & Touche[7] was contracted by the IDA and CSA to conduct an industry survey of the Canadian fixed income markets. The report included a consensus view "to increase transparency incrementally to benefit the market in the long run, but without exposing the dealers to too much additional risk, which would likely hurt liquidity". The Bank of Canada[8] wrote "While greater transparency is generally supported, our perspective has been that transparency requirements be designed so as to not adversely affect the price-discovery mechanism or market liquidity….One consideration is the need for an equitable, but appropriately differentiated, regulatory framework, recognizing similarities and differences in market structures."

>> Both investors and liquidity providers require confidentiality in small markets, so that they can operate without prejudice in the presence of competitors and other opportunistic participants.

There is added complexity when dealing with transparency in micro-market environments that are so small that trading activity can identify a client, and trade data can be used to reverse-engineer portfolios. As stated above, both investors and liquidity providers require confidentiality in small markets, so that they can operate without prejudice in the presence of competitors and other opportunistic participants.

7 Deloitte & Touche: IDA/CSA Market Survey on Fixed Income Markets; July 16, 2002

8 Bank of Canada Financial System Review: Transparency in the Canadian Fixed-Income Market; Opportunities and Constraints, Tran Minh-Vu; December, 2003

Since 2002, there has been marked improvement in the quality, timeliness, and access to reliable price information for Government of Canada, Provincial and Agency bonds, and Canada Treasury Bills. The introduction and adoption of CanDeal Composite Prices has proven to be a milestone event that, when viewed holistically with the RFQ process, has achieved information and market consolidation. Security valuations are continuously received from dealers' internal trading systems and processed, using CanDeal's proprietary algorithms, to create composite prices that are validated for quality control by institutional-sized trades in the market. CanDeal's price screens are dynamic, being derived from hundreds of thousands of dealer-price updates in a given day.

CanDeal Composite Prices are timely, accurate and reflect both the bid and offer side of the market for each security, and they are available in real-time.

CanDeal's Composite Prices and electronic marketplace have contributed to foreign institutions entering in the Canadian debt markets because they are able to monitor and compare Canadian prices with other sovereign markets in real-time, then instantly access liquidity using the RFQ trade protocol.

Many have argued that CanDeal's Composite Prices have enhanced the market's ability to develop consensus on security valuations since CanDeal's introduction in 2002, while promoting price transparency and market liquidity. CanDeal expects that with the introduction of composite pricing and the RFQ trade protocol to the Canadian Dollar Interest Rate Swap market, we will see similar improvements to transparency and market efficiency.

Regulation – OTC Derivatives Reform

CanDeal recognizes the unique requirements of institutional and retail investors, and fully supports suitable regulation of these disparate client groups.[9] That said, OTC derivative markets are necessarily institutional, with institutional-sized risk, and require an institutional regulatory solution.

It is apparent to CanDeal that the rule-making process in the United States has been disrupted by the politically-charged environment present in that country. This has resulted in a loss of focus on certain primary goals – in particular, migrating trading to electronic venues. As well, their proposed rules have unnecessarily and intrusively ventured into micro-managing market protocols at the risk of sub-optimal market operation.

>> Canadians can create harmonized rules that strike a balance between adherence to systemic-risk principles, while respecting the uniqueness and integrity of our marketplaces

CanDeal supports Canadian legislators and regulators charting their own course in assuring the protection of our financial markets and their participants. Canada has a uniquely centralized, federally-chartered banking structure that is proven successful at avoiding many of the failures experienced externally, and Canada is not encumbered by the political environment present in the United States. CanDeal believes that Canadian regulators can choose to define a fundamentals-based regulatory environment and not adopt a "cut and paste" approach. Canadians can create harmonized rules that strike a balance between adherence to systemic-risk principles, while respecting the uniqueness and integrity of our marketplaces; and not over-engineer the framework where we may lose sight of, or cause delays in achieving, our greater goals.

9 Retail investors and consumers indirectly receive financial benefit from the fair and efficient operation of institutional OTC debt and derivative markets, through their participation in public and private pension plans, insurance policies, annuities, mutual funds, etc.

Summary

CanDeal believes that the Canadian financial markets are unique, and that the Canadian regulatory solution can be distinct from others while respecting our commitments to G20 partners. There is experience in the evolution of the global debt and derivative markets that can be studied to help define a workable regulatory environment for Canadian dollar denominated OTC derivatives.

Leading dealers, together with institutional-investor clients, have expended considerable resources over a fifteen year period to define and evolve electronic trading and post-trade solutions that best meet the needs of all parties. These solutions accommodate trades of exceptionally large economic value and financial risk. Dealers incur significant financial and non-financial costs in servicing the needs of their institutional clients. Institutional investors, issuers and hedgers place great value on their dealer relationships and the services they receive.

The evolved RFQ trade protocol continues to be embraced by the buy-side as the preferred market solution because of the liquidity, financial surpluses, flexibility, discretion, transparency and efficiencies it provides.

CanDeal's composite prices have introduced a new form of price transparency to the Canadian debt markets that has fundamentally altered and improved how market participants and stakeholders monitor the markets and develop consensus on security valuations.

OTC debt and derivative markets continue to migrate trading away from the telephone to electronic marketplaces, with improvements to technology and trade protocols. As a leading conduit between buy- and sell-side participants, CanDeal is uniquely positioned to understand the complexity of these markets and the nuances that drive their efficient operation – in particular, their sensitivity to externalities and change.

CanDeal supports prudent regulatory reform of OTC derivative markets - reform that focuses on the broader objective of risk mitigation, without interruption or undo delay, and that takes an appropriate level of care to consider the institutional nature of these markets; while acknowledging and respecting that they are necessarily very different in structure and operation than central-limit-order-book based exchanges. Technology-driven change and the RFQ protocol have improved the risk profile and competitive position of institutional investors to the extent that they are now able to pro-actively manage their sources of liquidity and optimize the price discovery and trading process.

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