Transparency of Corporate Bond Markets
Supervision of Markets Division
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Summary

The purpose of this article is to provide a brief overview on the report "Transparency of Corporate Bond Markets" published by the Technical Committee of the International Organization of Securities Commissions (IOSCO) in May 2004 (available at the IOSCO website: http://www.iosco.org/pubdocs/pdf/IOSCOPD168.pdf). The report is based on a fact-finding survey of corporate bond markets conducted in member countries of the Standing Committee on Regulation of Secondary Markets (SC2). The surveyed information included trading methodologies, transparency arrangements and regulatory frameworks for corporate bonds, including trade reporting requirements. It found that transparency of listed bonds traded on exchanges is similar to that of other listed securities. There is less transparency in the over-the-counter (OTC) market although OTC trades are required to be reported in several countries. Based on the survey results, the report recommends a number of core measures highlighting what regulatory authorities should consider in enhancing regulatory reporting and transparency in the corporate bond markets.

Scope of the Report

1. The report focuses on corporate bond markets to review market transparency issues. It considers the trading of listed corporate bonds traded on an exchange, listed corporate bonds traded off-market and unlisted bonds traded OTC. It also considers corporate bonds, whether listed or unlisted, trading on alternative trading systems (ATSs).

General Information on IOSCO

The IOSCO is an international association of securities regulators that was created in 1983. Its general secretariat is based in Madrid, Spain. The objectives of the organization's members are:

- to cooperate together to promote high standards of regulation in order to maintain just, efficient and sound markets;
- to exchange information on their respective experiences in order to promote the development of domestic markets;
- to unite their efforts to establish standards and effective surveillance of international securities transactions; and
- to provide mutual assistance to promote the integrity of the markets by a rigorous application of the standards and by effective enforcement against offenses.

Currently, the IOSCO has about 180 members from more than 100 jurisdictions. Its members meet each year at the Annual Conference. Hong Kong has been selected to host the 31st Annual Conference of IOSCO in 2006. This will be the first time that Hong Kong hosts the IOSCO Annual Conference.

The Technical Committee of the IOSCO

The IOSCO has set up a number of committees to manage its affairs. One of these committees is the Technical Committee. It is made up of 15 agencies that regulate some of the world's larger, more developed and internationalized markets. Hong Kong is a member of the Technical Committee. Its objective is to review major regulatory issues related to international securities and futures transactions and to coordinate practical responses to these concerns.

Mr. Andrew Sheng is currently the Chairman of the Technical Committee. The work of the Technical Committee is divided into the following five major functional subject areas:

- Multinational Disclosure and Accounting – Standing Committee 1;
- Regulation of Secondary Markets – Standing Committee 2;
- Regulation of Market Intermediaries – Standing Committee 3;
- Enforcement and the Exchange of Information – Standing Committee 4; and
- Investment Management – Standing Committee 5.

The Technical Committee has set up five specialized Standing Committees to address each of the above mentioned subject areas along with a number of Project Teams to fulfill short-term mandates. The members of the five Standing Committees and Project Teams meet several times during the year and tackle the mandates that they received from the Technical Committee.

1 Views expressed in the paper do not represent those of the SFC.
2 The objectives of the IOSCO and the functions of its Technical Committee are found in the following feature box.
3 The SC2 member countries are Australia, Brazil, Canada (Ontario and Quebec), France, Germany, Hong Kong, Italy, Japan, Malaysia, Mexico, Singapore, Spain, Switzerland, United Kingdom and United States.
4 The report defines "off-market" as the execution of trades of corporate bonds listed on an exchange occurring off that exchange.
5 The report defines "OTC" as over-the-counter, bilateral trading of unlisted corporate bonds.
6 In Hong Kong, alternative trading systems are known as Automated Trading Services.
General Characteristics of the Corporate Bond Markets

2. SC2’s survey reveals that corporate bonds traded in SC2 member countries have various characteristics. An important development in recent years is that the structures of corporate bonds have become more and more complex. For example, a corporate bond may contain call provisions, embedded options or conversion rights.

3. In respect of trading methodology, a majority of bond trading in most SC2 jurisdictions occurs bilaterally, dealer-to-client. Much of this bilateral dealing takes place by telephone, but a growing number of dealers are providing electronic order routing and order-execution facilities. Over the last decade, the rapid evolution of electronic order-handling technology has not only enabled dealers to improve client access and automate some trade execution, but has also led to the launch of a number of fully electronic trading platforms for corporate bonds. A number of exchanges have adopted these systems, but in some countries, this type of trading systems has more commonly been offered by ATSs. ATSs providing trading in corporate bonds have been very popular in Canada and in the US since the mid-1990’s. Italy, Hong Kong and the United Kingdom also have ATSs trading corporate bonds. However, in many jurisdictions, the most active market place for corporate bonds is still the OTC market.

4. Institutional and/or sophisticated investors appear to be the predominant investors in corporate bonds in most markets. However, retail investors appear to be participating in greater numbers than in the past. Most SC2 members perceived that the corporate bond market is growing, both in terms of the number of issues and the value of trading, though not necessarily on a year-to-year basis or across all jurisdictions.

Transparency of the Corporate Bond Markets

5. Transparency refers to both pre-trade and post-trade information. Pre-trade information relates to the posting of firm bids and offers which enable market participants to know whether and at what prices they can trade. Post-trade information relates to the prices and the volume of all individual transactions actually concluded. It provides market participants with information about the most recent trading in the market and will assist them in assessing the quality of execution.

6. The SC2 survey discovered that trading in corporate bonds on exchanges is generally quite transparent, with order and trade information easily accessible to market participants and the regulatory authorities. In most SC2 jurisdictions, pre-trade and post-trade transparency requirements for bonds listed on an exchange are broadly similar to those for other securities traded on the exchange. On the other hand, there is less information available when listed bonds are traded off-market, including on ATSs, although some SC2 jurisdictions require off-market trades to be reported to the exchange on which the bond is listed.

7. In most SC2 jurisdictions, there are very few transparency requirements applicable to OTC trading. Trade information about the OTC market, in particular pre-trade information, is limited. Nevertheless, this has started to change in some jurisdictions, partly as a result of the greater transparency brought about through the development of ATSs but, also in the case of Canada and the US, through a more systematic regulatory approach to corporate bond transparency.

8. In the US, the National Association of Securities Dealers (NASD) launched a trade reporting and
trade publication system (known as TRACE) in July 2002. TRACE is a system that provides post-trade transparency and disseminates trade information to market users. The programme has been progressively increasing the number of debt securities subject to post-trade publication and currently provides post-trade information on bonds accounting for almost 75% of total trading volume in investment grade corporate bonds and 50% of the more liquid high yield bonds. Table 1 provides a more detailed description of the TRACE system.

9. For corporate bonds traded on multiple market places, their post-trade information may or may not be consolidated. Regulators in some jurisdictions have brought about varying degrees of consolidation of post-trade data, mainly by requiring consolidated trade publication for trading in all listed bonds. For example, some exchanges providing trading in listed corporate bonds consolidate the data for all trades of those bonds, whether they occur on or off the exchange. In a few SC2 jurisdictions, there is some consolidation of information relating to trades of unlisted bonds that occur OTC.

Regulatory Framework

10. Generally, the statutory requirements applicable to trading of corporate bonds are similar to those that apply to trading of equity securities. In all SC2 jurisdictions, manipulation, fraud and insider trading prohibitions apply to both equity and debt securities. The differences arise in the implementation of requirements for the listed and unlisted markets and the approach to monitoring and surveillance, including trade reporting.

11. For listed corporate bonds, exchanges are generally responsible for monitoring this trading, in real-time and/or on a delayed basis, to detect breaches of their rules or aberrant or abusive trading. If the listed bonds are traded on an ATS, the regulatory authority or a self-regulatory organization (SRO) may monitor and supervise real-time trading on the ATS.

12. In many SC2 jurisdictions, trade information regarding unlisted corporate bonds is not reported to the regulator or to an SRO and there is little real-time surveillance, monitoring and reporting conducted by the regulatory authorities or the SROs. For the most part, regulatory authorities generally seek to ensure compliance with statutory requirements in the OTC markets after the fact, through examinations of (or requests for information to) market participants or through investigations. However, several jurisdictions do require regular reporting of all OTC trades in corporate bonds to a regulatory authority, an SRO or industrym body.

13. Regulatory authorities have in the past tended to focus less on overall transparency in the corporate bond market than in the equity market given the bond market's mainly institutional participation and the fact that the implementation of transparency requirements would have been expensive due to the predominantly manual processing of orders and trades. For this reason, many regulatory authorities have only limited information on OTC trading in their corporate bond markets.

14. However, in view of the evolution of the corporate bond market, and in particular its growing complexity and broader participation, regulators have recently been reassessing the adequacy of the market's transparency. Of particular interest are the nature of pricing and the growing number of factors that may influence pricing. These seem to indicate that the information contained in trading may be of greater importance than in the past.
Reporting Requirements

15. Since regulatory authorities have traditionally focused on the regulation of "organized markets" and market integrity issues relating to the equity market, few jurisdictions other than the US collect data regarding OTC transactions for corporate bonds.

16. Where corporate bonds are traded on-exchange, there should normally be a good flow of information flowing to those responsible for market monitoring. However, reliable information regarding OTC trading generally is not available to regulators because most SC2 jurisdictions do not require reporting on a trade-by-trade basis.

17. Although there is little evidence that there is significant abuse in these markets that goes undetected, an important consequence of this limited information on market activity is that regulatory authorities may not have sufficient information to develop effective regulatory tools, may have perceptions of what is going on in the market that are not always accurate and may be slow in becoming aware of, and responding to, any new risks.

18. As a consequence, the issue of what reporting a regulator should require beyond the listed and/or on-exchange markets arises. In light of the growing participation in the corporate bond market and the fact that technology facilitates trading by more and a wider range of participants, the regulatory authorities and the SROs may need to set requirements that seek to ensure that there is enough information available to monitor and conduct surveillance appropriately in the OTC corporate bond market.

Conclusion and Recommendations

19. The SC2 survey revealed that most secondary trading of corporate bonds is done off-market or OTC and that there is an absence of substantial information available to the public on this trading in most jurisdictions and, in particular, regarding unlisted corporate bonds.

20. A number of changes and development in recent years in SC2 jurisdictions have triggered the need to review the transparency of the corporate bond market. The introduction of TRACE is a significant development in the US. It provides a very good example of how to enhance regulatory reporting and market transparency of the corporate bond market. Information provided by systems like TRACE enables regulatory authorities to assess the status of, and monitor trading in, the corporate bond markets. It also provides the public - both retail and institutional investors - with information that enables them to assess whether they are obtaining fair and reasonable prices for their trades.

21. The report recommends 5 core measures highlighting what regulatory authorities should consider in regulating the corporate bond market. Among these measures, 3 measures are aimed at setting out the regulatory framework for regulation of the corporate bond market, 1 measure is for the purpose of enhancing the transparency of the corporate bond market and 1 measure is on consolidation of price information of corporate bonds traded on different venues.

22. The core measures proposed by the report are summarized as follows:

Regulatory framework

Core measure 1

23. Regulatory authorities should obtain information regarding the characteristics of the corporate bond market. This information should include:

- the types of bonds traded,
- the size of the market, including trading volumes,
• the composition of investor participation,
• the credit rating of the issues, and
• the structure of the corporate bond market, including the trading methodology and the price formation process.

Core measure 2

24. To the extent permitted by law, regulatory authorities should implement trade (or transaction) reporting requirements for corporate bonds and if there are impediments to doing so in their regulatory structure, they should, to the extent possible, seek changes or alternatives.8 These requirements should take account of the type of trading methods used and the resources available to the regulators for receiving and analyzing the data in a meaningful way.

Core measure 3

25. Regulatory authorities should have in place appropriate information gathering and surveillance methods or systems for trading in the corporate bond market in order to promote the integrity of the market, including best execution and other investor protection requirements. The design of any system should take into account the type of trading activity and investor participation in the market.

Transparency

Core measure 4

26. Regulatory authorities should assess the appropriate level of transparency in the market for corporate debt to facilitate price discovery and market integrity. In determining the appropriate level, regulators should take into consideration a number of factors, including:
• the size of the market,
• the frequency of trading of particular bonds or group of bonds,
• participants in the market,
• the credit ratings of the issues,
• the trading methodology,
• the potential effects of any disclosure on the liquidity of the market, and
• whether the bonds are listed and the existing exchange transparency standards.

Consolidation

Core measure 5

27. If transparency of trading data exists but the data is not consolidated, regulatory authorities should determine whether there are any impediments to consolidation and whether regulatory action is required. ☐

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8 Some jurisdictions differentiate between trade and transaction reports, with trade reports normally being real-time reports and transaction reports a more detailed, end of session report. In addition to such trading data, some jurisdictions may also require reporting of custody data.
Following regulatory concerns in the US regarding the lack of transparency in the corporate bond market, the National Association of Securities Dealers (NASD) launched the TRACE system for reporting and dissemination of last sale information on corporate bonds on July 1, 2002. TRACE is a system that provides post-trade transparency and disseminates trading information to market users, but does not provide pre-trade transparency. TRACE is being implemented in phases. NASD rules require dealers to report trades on all eligible US corporate bonds to the NASD within 45 minutes.

While liquidity of a corporate bond is not a factor in deciding whether a transaction is reported to TRACE, it currently disseminates transaction information to the public on

(i) investment grade corporate bonds with initial issuance size of $1 billion or greater,

(ii) investment grade corporate bonds rated "A3" or higher by Moody's Investors Service, Inc., and "A-" or higher by Standard & Poor's, with initial issuance size of $100 million or greater,

(iii) 120 bonds designated by the NASD that are rated "Baa/BBB" at the time of designation, and

(iv) approximately 50 high-yield debt securities (together, "TRACE-eligible" debt securities).

In the US, for "TRACE-eligible" debt securities, the actual quantity of the transaction is disseminated if the total par value of the reported transaction is $1 million or less; if the reported amount is greater than $1 million, a large volume trade dissemination cap identifier of "1MM+" is disseminated instead of the actual quantity.

The data currently disseminated through TRACE includes transaction information on more than 4,200 securities representing about 75% of the dollar value of trading activity in investment grade bonds. The NASD makes this information available at no cost to investors on its website (on a delayed basis with a minimum four-hour time lag). Real-time price data is available from several third-party data vendors at additional cost.

The NASD, after consulting with an advisory committee of industry representatives, has been directed by the SEC to consider expanding the universe of bonds that are subject to dissemination through TRACE. The NASD Board of Directors recently approved a proposal presented by that advisory committee. That proposal would make public in near real-time 99% of trades overall, with delayed publication of trades in certain new issues and of large transactions in infrequently traded high-yield bonds. The proposal will have to be filed with the SEC. In addition, the NASD proposes to reduce the reporting period to 15 minutes once the industry acquires greater experience with reporting.

Dissemination of last sale data on corporate bonds through TRACE has significantly improved the transparency of the U.S. corporate bond market. In addition, because transactions data in all eligible bonds is reported to TRACE and available to the NASD for surveillance purposes, TRACE has enhanced the NASD’s ability to conduct surveillance of the market.