31st Annual Conference of
The International Organization of Securities Commissions (IOSCO)

8th June 2006
Hong Kong

Panel 3: Bond Markets – Should Their Transparency be Enhanced?

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Speech by SEC Commissioner: Remarks before the 31st Annual Conference of IOSCO in Hong Kong Panel 3: Bond Markets - Should Their Transparency be Enhanced?

by

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Hong Kong
June 8, 2006

Hello. First, I'd like to thank Arthur Docters van Leeuwen for inviting me to participate on this panel - Bond Markets - Should Their Transparency be Enhanced? Transparency is a universal concern for regulators worldwide, whether it be in the debt market, the equities market, the options market or elsewhere. The concern also may be specific to a novel product, a strategy of trading, or as a matter of disclosure for purposes of evaluating governance or issuer conduct. Whatever the impetus, regulators have to balance the costs of the obligations associated with the transparency requirements with the benefits that such transparency will produce.

Because time is short today, I will jump to our specific topic - transparency in the bond market. I also will remind you that the remarks I give today are my own and do not represent the US SEC, my fellow Commissioners or the Commission staff.

When discussing the US bond market initiatives, it is important to note that such initiatives focus on post-trade transparency. That is, information about trade executions. US transparency efforts to date do not include information about dealer quotations, customer orders or dealer identities. With that in mind, let me briefly outline the US history of bond market transparency.

Originally, there was an active US exchange market in corporate and municipal bonds. With the close of the 1920's, trading in municipal securities migrated to the over-the-counter (OTC) market. Corporate bonds followed suit in the mid-1940s. This shift may have been in response to the changing investor base of institutional investors and the ability to trade in a dealer market. It was not until 1975 that the Municipal Securities Rulemaking Board (MSRB) was created. Then, in 1986, with the enactment of the Government Securities Act, government securities dealers were required to register, the Treasury was given certain rulemaking authority over government securities dealers, and the dealers' associated persons became subject to NASD oversight with respect to sales practices. Regulation had arrived in the bond market but transparency was still noticeably absent.

In 1994, the MSRB committed to implementing trade reporting requirements, with the culmination of real-time reporting for municipal securities in January 2005. The steps to transparency began with daily summary reports of inter-dealer trades in 1995; customer trades were added in 1998; next day transaction information for frequently traded bonds was implemented in 2000, with all bonds following in 2003; and, 15 minute reporting and real-time transparency became effective in January 2005. Currently, the Real-time Transaction Reporting System (RTRS) serves most of the 1.5 million in municipal securities issues, minus a few limited exceptions.

On the corporate side, in 1994, the NASD developed its Fixed Income Pricing System (FIPS) in response to concerns over market abuses in the high-yield market and the urging of former Chairman Breeden after the Drexel Burnham Lambert scandal. Noting that FIPS did not go far enough, in 1998, Former Chairman Levitt urged the NASD to build, and in January 2001 the Commission approved, the Trade Reporting and Compliance Engine (TRACE). TRACE began reporting a subset of corporate bond trade information in July 2002, with a timing requirement of 75 minutes after trade execution. That timeframe was subsequently reduced to 45 and then 30 minutes. On July 1, 2005, the reporting window was narrowed to 15 minutes. This past January (2006), the Commission's approval of the immediate dissemination of TRACE price and transaction data became effective. Accordingly, TRACE now disseminates real-time information on more than 29,000 corporate fixed-income securities, including investment grade and high-yield debt securities, within 15 minutes after execution.

You may ask, why TRACE and why RTRS. The answer is simple. By the end of 2005, outstanding corporate and municipal debt in the US totaled $5.35 trillion and $1.86 trillion, respectively (according to Federal Reserve data). Transparency has dispelled the misconception of who is a bond buyer and led to the realization that approximately 2/3 of all reported trades in corporate bonds are retail investors (ie., trades of less than $100,000). These two facts together should be enough to concern any regulator.

However, we at the SEC had to measure our concerns against the doomsday predictions that price transparency would discourage dealers from committing capital, assuming risk and providing liquidity. Accordingly, the Commission approached the issue cautiously and carefully, phasing in transparency and providing exceptions where necessary. For example, reports of the largest trades still are made with volume caps, to recognize the sensitivity of this market information.

The doomsday predications fell flat. At a conceptual level the empirical evidence to date suggests that the impact of transparency on the bond market has been quite beneficial. There seems to be little evidence that liquidity deteriorates after the market becomes transparent. In fact, SEC staff economists as well as several academics are finding that increases in transparency reduce transaction costs for trades of all sizes and do not minimize liquidity. The various studies of trade reporting suggest that spreads tighten after the market becomes transparent. (Bessembinder, Maxwell and Venkataraman (2005); Hotchkiss and Sirri (2005); Edwards, Harris and Piwowar (2005)). In the 2005 Bessembinder, Maxwell and Venkataraman study, for example, the authors found that after the initiation of TRACE reporting, large sophisticated investors found a 50% reduction in trade execution costs. The study also noted that there is a reduction of 20% for the bonds not eligible for TRACE - perhaps a spillover effect of TRACE reporting. Despite this ambiguity as to the exact magnitude of reduction attributable to TRACE, the reduction in costs, even for institutional trades is tremendous.

Putting a dollar value to some of these percents, OEA staff (Edwards, Harris and Piwowar 2005) studied transaction costs in bonds before and after transaction reporting also concluding that costs are lower for bonds with transparent prices and that both large and small investors benefit. The staff's results suggested that $1 billion in additional savings would have been realized by investors in 2003 if all corporate bond prices had been transparent throughout the entire year. (Results suggest that customer transaction costs decreased by roughly 5 basis points. There were more than $2 trillion in 2003 volume in non-transparent corporate bonds. Five basis points of $2 trillion is $1 billion dollars.) And this may only be the tip of the iceberg. There is a circular benefit to transparency wherein increased investor demand has the potential to lead to increased demands for transparency, thereby further driving down transaction costs. Said another way, with more and better information, liquidity will improve, transaction costs will continue to lower, and issuers will be able to access capital at lower costs.

Transparency has brought and will increasingly bring other benefits to the bond market in addition to lower transaction costs. The availability of timely price information promotes fair and efficient pricing by aiding investors and dealers in evaluating the current bid or ask price. Information that is timely, accurate, and easily accessible - which the regulators can ensure - allows investors to make more informed decisions. In addition, the knowledge that all market participants are subject to the same reporting rules and see the same price information, creates certainty, fosters investor confidence and promotes participation in the markets.

Compliance, examination and enforcement have been enhanced by TRACE and RTRS too. There are two components to this improvement. First, in an expanding bond market, everyone must play their part. Effective compliance practices must be undertaken by bond market participants and effective examination and enforcement must be employed by the Commission and the SROs. Remember, with respect to FIPS, TRACE and RTRS, the SEC asked the industry SROs to develop the reporting systems, through active consultation with the SEC and the bond market participants.

Second, it is important to note that there is significant value from the reporting of trade information as distinguished from the dissemination of this information to the public. Even if not all of the transaction information is made available to market participants, the public can benefit from central trade reporting because regulators will have better market insights. These improved insights allow regulators to better carry out their investor protection mandate by, for example, identifying firms to examine in its review process. Regulators also can detect excessive markups and markdowns using TRACE and RTRS data to look for abusive patterns of conduct. They can use the data to examine for unfair pricing practices and to identify daisy chain manipulative activity. Compliance with best execution and suitability obligations can be monitored more easily as well.

Specifically, central reporting allows regulators to more effectively and efficiently police and enforce rules and standards, as well as appropriately revise such rules and standards as necessary based on observed trends and data. It also gives regulators a greater ability to conduct low cost monitoring.

Transparency combined with other developments in the bond market has further stimulated the business. Significant improvements in the fair valuation of bond mutual funds are now possible. Thus, issuers benefit from a lower cost of capital due to the improvements in the secondary market liquidity of their bonds. Market share of the largest dealers has decreased, suggesting that the corporate bond market has become more competitive following the initiation of TRACE and RTRS. Plus, broker-dealers have had the opportunity to adapt to meet the new investor demands for bond market products and services facilitated by price transparency. In fact, to attract business, one large US broker-dealer announced improved retail access to market data, a simplified retain pricing schedule, and 50% discounts for online bond trades.

The bottom line is that data integrity is essential to achieving all of these benefits that I have discussed.

Let me make some quick observations about the future of transparency in the US bond market, because the ball has not stopped rolling. For example, the academic studies document surprisingly large spreads in the municipal bond market, especially when compared with the equities market. Interestingly, these spreads decline with the size of the trade, unlike exchange-based trading in equities. This phenomenon runs counter to the usual argument against transparency that dealers need time to work large orders; if this argument is correct, it would suggest that the spreads and price impact of large orders would be substantially greater than for small orders. That does not appear to be the case. Instead, the culprit may be the lack of transparency and the fact that institutions have better price information than retail investors in this opaque arena.

Another potential development that may increase transparency in the US bond markets is that the NYSE has petitioned the Commission to grant exemptive relief to allow it to provide a market for trading more bonds. Currently, the NYSE's Automated Bond System (ABS) provides a market for less than 1% of corporate bond trading due to a prohibition in the Exchange Act that limits NYSE members to quote only the bonds of issuers that are registered with the Commission. In contrast, debt securities may trade in the OTC market absent Exchange Act registration. According to the NYSE, 92% of the par value of all debt traded in the US capital markets is traded OTC due, in part, to this disparate regulatory treatment. The NASD argues that trades in unlisted bonds effected through ABS are actually OTC transactions subject to its oversight, and that the Commission's key consideration should be to protect against the fragmentation of information to bond investors.

The Commission has noticed the NYSE's exemptive request for public comment and is reviewing the comment letters. Granting this request has the potential to increase transparency in the bond markets because bonds traded through ABS are reported instantaneously. Further, investors can see bid and ask quotations and last sale prices, exclusive of any mark-ups, mark-downs, or other changes. In addition to the advantages of greater transparency and disclosure if the exemptive relief is granted, investors may also benefit from the increased competition among bond markets in the US. The key to reviewing the request is to balance the proposed relief with the potential loss of the comprehensive public information that an issuer must provide under Exchange Act registration.

I began my remarks by noting that US transparency initiatives have been limited to post-trade transparency. An interesting question is whether we also should focus on pre-trade transparency. As previously noted, there was an active exchange market in corporate bonds and municipals prior to World War II. Given the current ability to utilize electronic and Web-based platforms and tools, such a thought is not completely unforeseeable.

In conclusion, I would argue that transparency increases investor confidence and is an essential component of efficient and fair markets. It reduces transaction costs, improves the pricing mechanism, promotes investor confidence, aids in compliance and surveillance, and lowers the cost of accessing capital. I am not suggesting that regulators run willy-nilly into full transparency from a black box. It may be that the optimal degree of transparency reflects a certain degree of opacity, but I do believe that empirical evidence in the US example supports significant transparency in the bond market. It's good for the regulator but, more importantly, it's good for the market and the investors.

http://www.sec.gov/news/speech/2006/spch060806.htm