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Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC.

Global Risk Watch Newsletter

The Chinese economy at risk of facing several structural challenges, etc.

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 # Dilemma between transparency and liquidity (Shiro Katsufuji, Director, Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC)

Regulatory reform is moving forward to enhance transparency in market trading. MiFID2/MiFIR in Europe is a pioneering example. The regulation is planned for implementation in 2018, for which market participants are adding final touches to trade reporting systems and process development to comply with transparency requirements. This new regulation establishes pre-trade and post-trade transparency regimes. The former requires investment firms and trading facilities to disclose bid and offer prices in derivatives trading as well as “depth of trading interest” at those prices during normal trading hours while the latter demands publication of price, volume, and time of the instruments’ transactions as close to real time as possible. Furthermore, MiFID2/MiFIR obliges investment firms to provide in advance clients with information on costs and fees relevant to investment advisory.

In the foreign exchange (FX) market, the Global Foreign Exchange Committee released the FX Global Code in May 2017. As Principles on Execution, the Code expects market participants to ensure fair handling of stop loss orders, fair and transparent pre-hedging of client orders, and more transparent client spread and commission charges. Market participants are supposed to document and publish policies and procedures on client order execution. Principal transactions (where financial institutions serve as a direct trading counterpart to a client) are mainstream in the FX market as opposed to agency transactions (where brokers serve as a client’s agent in the market for fee) predominant in the stock market. Therefore, unlike statutory restriction on traders in the stock market (ban on front running, bucketing, etc.), the code of conduct in the FX market has relied on market

participants' own initiative. The FX Global Code is a notable progress based on consensus between regulators and market participants to visualize the voluntary code in an official format, and improve the market transparency.

Moreover, international standard setting is proceeding in the corporate bond market to better transparency before and after transactions. In August 2017, the International Organization of Securities Commissions (IOSCO) published a consultation report "Examination of Liquidity of the Secondary Corporate Bond Markets." It recommends that regulators in respective countries should establish reporting requirements for pre-trading and post-trading, and promote development of the prudent and efficient market.

These regulatory reforms for higher transparency in market transactions aim to protect investors by securing opportunities for price discovery, and to prevent unfair price manipulation by traders. It reflects a lesson from index manipulation like the Libor scandal and opaque pricing of securitized products prior to the global financial crisis, which crucially undermined investors' interests. Particularly for financial instruments traded in over-the-counter (OTC) markets, investors may not have access to sufficient information to judge fairness of offered prices as their pricing mechanism is not disclosed. The recent reform to improve transparency will contribute to higher market liquidity as well as OTC markets with minimized market distortion by providing investors with fair opportunities for price discovery.

On the other hand, there is also a possibility for lower market liquidity of financial instruments at the cost of higher transparency. The cost for traders to comply with the new transparency regimes will increase, including IT development. Transparent pricing can discourage less competitive traders from taking part in market making, curbing a number of market makers. This would be more prominent for financial instruments traded through principal transactions at OTC markets. OTC markets deal with unstandardized instruments as a research and development field for new products that meet client needs. Possibly, primary focus on making OTC markets more transparent can lead to excessive homogenization of financial instruments, which constrains their diversity and liquidity.

Nonetheless, IOSCO analyzes that the correlation between transparency and liquidity is not always uniform according to multiple studies. The effects of higher transparency on liquidity vary depending on characteristics of products and markets in question.

The reform for more transparent market trade is a target both regulatory authorities and market participants need to achieve in order to protect investors and maintain fair market transactions. Simultaneously, it is necessary to proceed with the reform without spoiling market liquidity as well as environment to develop new financial instruments. Following the implementation of the new regulation, it remains crucial for regulators and market participants to assess the regimes' impact on the market and strive for optimal market growth as a whole.

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