Speech by SEC Chairman:
Summary of Remarks at a Meeting of OTC Derivatives Regulators

**by**

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## PRE- AND POST-TRADE TRANSPARENCY

### *Summary of Introductory remarks by Chairman Schapiro*

- In 2009, the G-20 Leaders made commitments regarding reforms to the OTC derivatives market with the objective of improving transparency, mitigating systemic risk, and protecting against market abuse.

- In October 2010, the FSB published recommendations regarding these commitments, which included the recommendation that authorities should explore the benefits and costs of requiring public price and volume transparency of all trades.

- Based on information provided by FSB member jurisdictions, it appears that pre-and post-trade transparency are areas where jurisdictions have room for significant advances.

- Some of the conversations among regulators around transparency have focused on specific requirements for trading, and the overall goal of improving transparency seems to be getting lost. Our goal today is to discuss improving market transparency. I think it would be beneficial and productive to focus our discussion in particular on the benefits and costs of post-trade transparency requirements for all OTC derivatives transactions, whether or not execution occurs on an exchange or electronic trading platform.

- There are a number of potential **benefits of pre- and post-trade transparency**

    - Generally, the benefits of market transparency flow from *reducing information asymmetries*.[1] In other words, under a comprehensive system of market transparency, all market participants (and potential market participants) have access to the same key information that insiders or professionals have, and at the same time.

        - In theory, the negotiating advantage that one party has over the other will diminish, making their relative positions more "symmetrical."

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[1] *See*, *e.g.*, Transparency of Structured Finance Products (Final Report), Technical Committee of the International Organization of Securities Commissions (July 2010) ("IOSCO SFP Report"), at 17, 21.

- Pre- and post-trade transparency allows market participants to have more accurate expectations for the price of a future transaction.

  - For example, an investor who wishes to buy a security can see current quotes or orders to sell, as well as prices of recent transactions. This pre- and post-trade information might alert investors to good opportunities to transact or deter them from transacting when market conditions are not advantageous.

- Pre- and post-trade transparency create a feedback loop.

  - When post-trade transparency exists, even in less than comprehensive form, transactions are more likely to occur at or near the published prices. When market participants decide at what price to display quotes or orders, one of the significant factors they take into account is the price at which recent transactions have occurred.

  - The result is a more efficient market, as it becomes less likely for a particular trade to be executed at an anomalous price.

- Market transparency allows market participants to better assess the quality of executions effected by their intermediaries.[2]

  - For example, an investor can compare the price of her execution against prices of quotations in the market and other transactions done at the approximately the same time as her execution, and question the intermediary about any discrepancy not to the investor's advantage.

  - Intermediaries, knowing that investors have information to assess the quality of executions, have greater incentive to provide best executions and thereby avoid disputes with customers.

- Market transparency can provide incentives for new participants (such as smaller market makers, buy-side institutions, or retail investors) to enter the market, thus increasing competition and reducing concentration in the market.

  - A potential entrant can see prices of current quotations as well as prices of recent trades in an instrument, and can thereby assess whether it can offer a better price. If it can, a pre-trade transparency system will announce that better price to the market.

- The benefits of pre- and post-trade transparency can improve the perceived fairness of the market and encourage wider participation,[3] thus leading to greater price competition and narrower spreads.

[2] *See*, *e.g.*, IOSCO SFP Report at 21.

[3] *See*, *e.g.*, IOSCO Report on Transparency and Market Fragmentation at 4.

        - Enhanced liquidity can reduce price volatility, as enhanced liquidity implies that there are more buy and sell orders in the market to absorb trading interest without moving prices significantly.

    - Market transparency also enhances competition among multiple trading venues.

        - Enhanced competition could result in better prices and lower costs for investors. This effect would likely to be increased to the extent to which these market data are consolidated (whether by private actors or pursuant to regulatory mandate).

    - Market transparency also helps promote some degree of *de facto* integration of fragmented markets.

        - If order flow is dispersed among multiple trading venues, the same product may trade at different prices in different venues.

        - The greater the degree of transparency, the less likely market participants are to trade outside the best prices, thereby providing some incentive for fragmented markets to converge on the best prices.

    - Market transparency can aid asset holders generally, even those who do not actively transact, by offering them better information for valuation.[4]

        - The asset holder can see prices at which other market participants have recently sold, or the price at which a market participant currently would buy the instrument from the current holder.

        - Better valuation can assist capital formation by providing better inputs into an asset holder's analysis of whether to buy, sell, or hold. Better valuation also aids in prudential and systemic risk management, as accurate valuation is instrumental in assessing an institution's solvency.

- There also are **potential costs of post-trade transparency**

    - One assertion regarding costs of post-trade transparency is that it may lead to decreased liquidity. For example, narrower bid/offer spreads may result in lower profits for incumbent market makers, thus reducing their incentives to provide liquidity. The argument is that post-trade transparency provides customers with relevant information about recent trade prices that they can use to their benefit in price negotiation (i.e., demanding a higher bid or lower offer) for their trade. Also, post-trade transparency informs all market participants about recent price levels for transactions and may result in new competitors entering the market and competing for customer business with higher bids or lower offers, thereby narrowing bid/offer spreads.

[4] See, *e.g.*, IOSCO SFP Report at 21-22.

- Post-trade transparency also may affect liquidity if it results in market makers holding less inventory due to perceived risks, such as the risk that it will be difficult or more costly to hedge positions following a large trade in a market with post-trade transparency. Market makers that perceive such risks in hedging positions may be willing to provide liquidity but may do so at increased prices to offset that risk.[5]

- Interestingly, a recent paper published by staff of the Federal Reserve Bank of New York regarding interest rate swap transactions found significant evidence that dealers lay-off a statistically significant amount of their trades within 30 minutes after execution of large customer transactions. This report concluded that with adequate protections that allow delayed reporting or masking of trade sizes, price reporting may not significantly impede market-making activity in interest rate swaps.[6]

***Discussion Topics (Chairman Schapiro to lead discussion)***

1. What are participants' views on using experiences with post-trade transparency in other financial instrument markets to inform efforts to implement post-trade transparency for OTC derivatives?

    a. Could post-trade transparency requirements potentially mitigate the effects of central clearing requirements to the extent these lead to greater market concentration?

2. What impediments or challenges would have to be faced in implementing post-trade transparency for OTC derivatives in your jurisdiction?

3. What are views on leveraging implementation of post-trade transparency for OTC derivatives to advance implementation of pre-trade transparency for OTC derivatives in your jurisdiction, or vice versa?

4. Are there approaches to implementation of pre- and post-trade transparency for OTC derivatives in your jurisdiction, such as staggered implementation based on participant or transaction type, that can facilitate your efforts?

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[5] See, *e.g.*, "Transparency and the Corporate Bond Market," Hendrik Bessembinder and William Maxwell, The Journal of Economic Perspectives, Vol. 22, No. 2 (Spring, 2008), pp. 217-234, at p. 228; "Transparency and Liquidity: A Controlled Experiment on Corporate Bonds," Michael A. Goldstein, Edith S. Hotchkiss, Erik R. Sirri, The Review of Financial Studies, Vol. 20, No. 2 (2007), pp. 235-273, at p. 239.

[6] See "An Analysis of OTC Interest Rate Derivatives Transactions: Implications for Public Reporting," Federal Reserve Bank of New York Staff Reports, March 2012, available at http://www.newyorkfed.org/research/staff_reports/sr557.pdf.