Sweet clarity

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ABSTRACT (ABSTRACT)

Take the NASD's dissemination of US corporate bond trading data. Under its Trace system, the regulator requires the reporting of transactions, which are then made public. Research to be published in the Journal of Financial Economics suggests that Trace, which began in 2002, has cut execution costs in half. That is clearly good for retail investors, who are responsible for a surprising two- thirds of corporate bond transactions. It is also good for buy-side institutions, especially smaller ones that had little negotiating clout with Wall Street.

FULL TEXT

That transparency is good for

markets is, for most, an article of faith. But can the bright light of scrutiny reveal too much information?

Take the NASD's dissemination of US corporate bond trading data. Under its Trace system, the regulator requires the reporting of transactions, which are then made public. Research to be published in the Journal of Financial Economics suggests that Trace, which began in 2002, has cut execution costs in half. That is clearly good for retail investors, who are responsible for a surprising two- thirds of corporate bond transactions. It is also good for buy-side institutions, especially smaller ones that had little negotiating clout with Wall Street.

On the other hand, big dealer banks now make less money on each trade. Few observers will lose much sleep over that. Nor is there much evidence for the claim that Trace - by making bond trading less lucrative for the banks - is to blame for a downward trend in bond trading volumes. One of the more likely explanations is an increasingly liquid, if opaque, market for credit derivatives, where hedge funds and others can bet on corporate credit without trading bonds.

That said, there are credible concerns. All well and good, dealers say, insisting on more transparency for bonds that trade frequently. But what about scarce issues for which a dealer has to scour the market to fill a customer's order? Revealing details that could identify the parties trading the bonds, even with a delay, could scare off some dealers and investors.

Studies on the impact of Trace have tended to focus on the early incarnations of the scheme - an initial 500 of the most heavily traded bonds and another 4,100 from 2003. Now, about 30,000 bonds are covered, some of which rarely change hands. There is the chance that what is good for the liquid end of the market could harm the illiquid end.

There, one can make a case for keeping some very specific data on trades confidential. But this should not discourage the NASD and other regulators from helping investors, especially at the retail level, get a clearer idea of actual bond prices.

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