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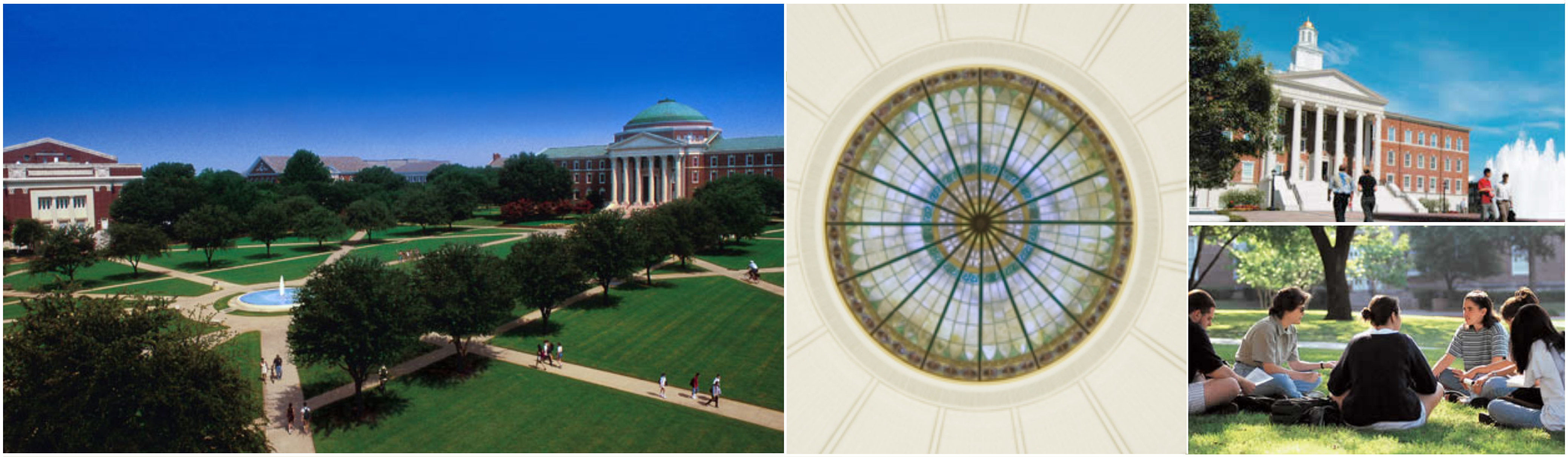

Securities and Exchange Commission
FIMSAC Panel – FINRA’s Block Trade Pilot proposal

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Comments

- Academic research: Initiation of TRACE trade reports.
- Possible explanations for the decline in block volume in corporate bonds between 2007 and 2019.
- FINRA's Block Trade Pilot proposal
  - Intended benefits
  - Unintended effects
- Summary

References

Qualitative discussion

Letter from FIMSAC Members Larry Harris, Kumar Venkataraman, and Elisse Walter (Aug. 21, 2018). *https://www.sec.gov/comments/265-30/26530-4268151-173129.pdf*

Survey of related academic research

H. Bessembinder, C. Spatt and K. Venkataraman. A Survey of the Microstructure of Fixed-Income Markets. Journal of Financial and Quantitative Analysis 55 (2020), 1-45. *https://doi.org/10.1017/S0022109019000231*

TRACE Timeline: Initiation of Transaction Reporting

Corporate Bonds (registered): 07/2002 – 02/2005

Structured Bonds: 11/2012 – 06/2015

Rule 144: 06/2014

Treasury: 07/2017 (data collection only)

Staggered rollout (in many but not all cases)

How did TRACE reporting affect Trading Costs?

Research Design:

– Measure market quality before and after TRACE initiation.

– Compare differences for treatment and control bonds.

Results:

- **Large reductions in customer's trading costs for all trade sizes**
  - Spill-over benefits due to matrix pricing for non-transparent bonds.

- **Institutions:** 40% to 60% reduction of pre-TRACE trading costs.
  - Gap in trading cost between small and large institutions decline.

- **Greater dealer competition:** Small dealers gain market share and close the trading cost advantage enjoyed by large dealers.

- Post Bond Offerings: dispersion in purchase price declines.

How did TRACE reporting affect institutional markets?

Examine TRACE initiation in <u>Rule 144A</u> Corporate and <u>TBA Agency</u> bonds

- These markets are dominated by institutional traders.

<u>Results</u>

- **TRACE initiation led to lower trading costs for institutions**.
  - Large reductions are <u>observed for blocks</u> exceeding $10 million.
  - **<u>No decline in block trading volume</u>**.

- **No reduction in capital commitment by dealers.**

- **No reduction in dealer’s propensity to facilitate block trades.**

- Small dealers improve terms for customers.

TRACE reporting in corporate bonds

- Bessembinder, H.; W. Maxwell, and K. Venkataraman. Market Transparency, Liquidity Externalities, and Institutional Trading Costs in Corporate Bonds" Journal of Financial Economics 82 (2006), 251–288.
- Edwards, A., L. Harris, and M. Piwowar. Corporate Bond Market Transaction Costs and Transparency. Journal of Finance 62 (2007), 1421–1451.
- Goldstein, M., E. Hotchkiss, and E. Sirri. Transparency and Liquidity: A Controlled Experiment on Corporate Bonds. Review of Financial Studies 20 (2007), 235–273.
- Hendershott, T., D. Li, D. Livdan, and N. Schürhoff. Relationship Trading in OTC Markets. Journal of Finance 125 (2020), 683-734.
- Jacobsen, S., and K. Venkataraman. Does Trade Reporting Improve Market Quality in an Institutional Market? https://ssrn.com/abstract=3171056.
- O'Hara, M., Y. Wang, and X. Zhou. The Execution Quality of Corporate Bonds. Journal of Financial Economics 130 (2018), 308-326.

TRACE reporting in structured bonds

- Friewald, N., R. Jankowitsch, and M. G. Subrahmanyam. Transparency and Liquidity in the Structured Bond Market. <u>Review of Asset Pricing Studies</u> 7 (2017), 316-348.
- Gao, P., P. Schultz, and Z. Song. Liquidity in a Market for Unique Assets: Specified Pool and To-Be-Announced Trading in the Mortgage-Backed Securities Market. <u>Journal of Finance</u> 72 (2017), 1119–1170.
- Hollifield, B., A. Neklyudov, and C. Spatt. Bid-Ask Spreads, Trading Networks, and the Pricing of Securitizations. <u>Review of Financial Studies</u> 30 (2017), 3048–3085.
- Schultz, P., and Z. Song. Transparency and Dealer Networks: Evidence from the Initiation of Post-Trade Reporting in the Mortgage Backed Security Market. <u>Journal of Financial Economics</u> 133 (2019), 113–133.

MSRB reporting in municipal bonds

- Harris, L. E., and M. S. Piwowar. Secondary Trading Costs in the Municipal Bond Market. Journal of Finance 61 (2006), 1361–1397.
- Li, D., and N. Schürhoff. Dealer Networks. Journal of Finance 74 (2019), 91–144.
- Schultz, P. The Market for New Issues of Municipal Bonds: The Roles of Transparency and Limited Access to Retail Investors. Journal of Financial Economics 106 (2012), 492–512.

What explains the block volume decline in corporate bonds between 2007 and 2019?

Explanation 1: TRACE trade initiation => **Rule it out**

- No changes in trade reporting between 2007 and 2019. TRACE reporting were initiated between 2002 and 2005.

Explanation 2: Banking regulation (e.g., Dodd Frank)

- Post-financial crisis **bank capital requirements** and the Volcker Rule reduced dealer inventory and capital commitment.
- See academic studies and reports by Fed economists discussed in Bessembinder, Spatt and Venkataraman (2020).

Explanation 3: Growth of Electronic Trading

- New technologies, market structure, and liquidity providers have evolved since 2007. **New equilibrium**.

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Capital Commitment and Illiquidity in Corporate Bonds

HENDRIK BESSEMBINDER, STACEY JACOBSEN, WILLIAM MAXWELL, and KUMAR VENKATARAMAN*

ABSTRACT

We study trading costs and dealer behavior in U.S. corporate bond markets from 2006 to 2016. Despite a temporary spike during the financial crisis, average trade execution costs have not increased notably over time. However, dealer capital commitment, turnover, block trade frequency, and average trade size decreased during the financial crisis and thereafter. These declines are attributable to bank-affiliated dealers, as nonbank dealers have increased their market commitment. Our evidence indicates that liquidity provision in the corporate bond markets is evolving away from the commitment of bank-affiliated dealer capital to absorb customer imbalances, and that postcrisis banking regulations likely contribute.

Impact of bank regulation on dealer capital

- Bessembinder, H.; S. Jacobsen; W. Maxwell; and K. Venkataraman. Capital Commitment and Illiquidity in Corporate Bonds. Journal of Finance, 73 (2018), 1615–1661.
- Bao, J.; M. O'Hara; and A. Zhou. The Volcker Rule and Market-Making in Times of Stress. Journal of Financial Economics, 130 (2018), 95–113.
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- Adrian, T.; M. Fleming; O. Shachar; and E. Vogt. Market Liquidity after the Financial Crisis. Annual Review of Financial Economics, 9 (2017), 43–83.
- Schultz, P. Inventory Management by Corporate Bond Dealers. Working Paper, University of Notre Dame (2017).
- Choi, J., and Y. Huh. Customer Liquidity Provision: Implications for Transaction Costs. Working paper, www.ssrn.com/abstract=2848344 (2017).
- Anderson, M., and R. Stulz. "Is Post-Crisis Bond Liquidity Lower?" Working Paper, www.ssrn.com/abstract=2943020 (2017).

FINRA's proposed pilot - intended benefits

Possible justification
OK. TRACE is not the cause of block volume decline between 2007 and 2019. But it is an easy, potential fix to address it.

What to expect with proposed pilot?

- Block trade volume is likely to increase.
- Large Institutions (who trade in blocks) and large dealers (who facilitate blocks) will clearly benefit the most. Why?

Transparency represents an information transfer. Proposed pilot provides information advantages to those trading in block sizes.

SUPER Blocks?: benefits even smaller set of participants.

FINRA's proposed pilot - unintended effects (1)

Who loses?

- Trading is a zero-sum game when measured in trading profits.
- Any cost savings that large institutions and dealers obtain are likely borne by their counterparties, grouped below:
  - Retail investors (70% of TRACE reports < $100,000).
  - Large institutions who trade patiently by splitting orders
    - See comment letters from Vanguard, Dimensional Fund Advisors, AQR Capital, among others.
  - Small Institutions & Portfolio Traders (ETF market makers).
  - Small (traditional) dealers.
  - Non-traditional liquidity suppliers in electronic platforms.

These counterparties are likely to experience higher trading costs.

FINRA's proposed pilot - unintended effects (2)

Decline in Data Quality (economically large)

Proposed pilot delays reporting for over 30% of investment grade bond volume and over 40% of high yield bond volume.

Increases information asymmetry, particularly in stress periods.

Dissemination of potentially misleading information

- Block sale is not reported but smaller offsetting buys are reported.

Trade reports play a critical role in evaluated pricing models.

- Users include mutual funds, ETFs, and trading desks.

Hinders technological innovations that rely on availability of timely, high quality data.

FINRA's proposed pilot design

Fully support FINRA's Randomized Control Design.

Genuine disagreements among both FIMSAC members and institutional investors on whether delayed reporting of trades helps or hurts markets.

- Concerns about Fairness (creating Winners and Losers) are mute. Why? We can't seem to agree on who will win and who will lose.

Control Group provides a baseline to measure treatment groups

- "Difference-in-difference" analysis will yield useful evidence under a broad range of market conditions (e.g., Covid-19 related stress).

Reduction in block trades – is this a problem?

- Remarkable growth in the corporate bond market
  - Robust New Issuance activity. High secondary market volume. No evidence of increase in trading costs.

- Bond Markets are less fragile in 2019 than 2007.
  - Less reliance few traditional, bank-affiliated dealers.
  - New types of (algorithmic) liquidity providers have emerged.

- Technology and innovation are transforming bond markets.
  - New instruments (ETFs) and venues (RFQ-platforms, ATS).
  - Heavy reliance on pre- (ATS quotes, RUNs) and post-trade data

<u>New ecosystem</u>

Are old metrics still relevant? Should we measure the health of the markets in other ways?

Summary

Agree. Dealers who facilitate blocks need to be protected.

FINRA's current trade dissemination policy:

- Protects the dealers by capping trade size disclosure.
- Recognizes that bond markets differ from equity markets.

Agree. Block trade volume has declined between 2007 and 2019.

- Other factors can help explain these patterns.

There is not sufficient justification for the proposed pilot.

- Large body of evidence that transparency benefits markets.
- No evidence that TRACE caused reduction in block volume.
- Unintended effects of proposed pilot are large.
- Proposed pilot is likely to hinder technological innovations that are transforming bond markets.

Vanguard ($6.2 Trillion AUM)

https://www.finra.org/sites/default/files/2019-06/19-12_Vanguard_Comment.pdf

We believe that the Proposed Pilot will harm investors and markets by significantly reducing post-trade transparency for a significant amount of trading activity, hindering the evolution and electronification of the corporate bond market, and creating an unlevel playing field without compelling justification. Although FINRA's Notice correctly identifies that improved post-trade transparency is associated with lower transaction costs, it fails to identify empirical evidence demonstrating that corporate bond liquidity is currently constrained by post-trade transparency. As a result, the Proposed Pilot is a harmful solution to an unsubstantiated problem.

I. The Proposed Pilot is Unnecessary.

II. The Proposed Pilot's Delayed Dissemination of Trade Data will harm investors and markets.

III. The Proposed Pilot is fundamentally flawed.

T. Rowe Price ($1.11 Trillion AUM)

https://www.finra.org/sites/default/files/2019-06/19-12_TRowePrice_comment.pdf

We do not believe the Pilot will improve market liquidity and we are opposed to launching the Pilot in its current form for a variety of reasons. The proposed 48-hour delay runs counter to our views on enhancing transparency, and as discussed below, it would discourage electronic trading and create other negative impacts.

We urge FIMRA, the SEC, and the Fixed Income Market Structure Advisory Committee to not pursue as proposed and instead identify opportunities to expand fixed income transparency in a balanced and measured way.

AQR Capital ($203 Billion AUM)

https://www.finra.org/sites/default/files/2019-06/19-12_AQR_Comment.pdf

We believe that reduced transaction costs are but one of the many market-wide benefits of transparency undermined by the proposed Pilot, and as a result, we cannot support this initiative.

..Our views on the proposed pilot are colored both by our belief in the benefits of transparency and concerns about its potentially detrimental impacts….We support regulatory efforts aimed at developing a 21st century fixed income market structure…..Unfortunately, the Proposed pilot does the opposite, by encouraging a revision to the market structure of the past rather than preparing our markets for the future.

Dimensional ($454 Billion AUM)

https://www.finra.org/sites/default/files/2019-06/19-12_Dimensional_Comment.pdf

We strongly disagree with the proposed pilot program…..

We also believe the pilot program will provide an information advantage to certain market participants and investors. This may also increase the trading costs for Main Street investors, mutual funds, and ETFs without necessarily providing any additional benefits.

We believe the currently proposed pilot program does not serve the long-term interests of investors saving for retirement or other future consumption needs. We find the proffered justification that the proposed reduced-price transparency will improve liquidity unpersuasive.

We are counting on our regulators to continue to strive to keep the markets fair for all participants. Please consider rejecting the flawed proposal for a 48-hour dissemination delay.

Citadel

https://www.finra.org/sites/default/files/2019-06/19-12_Citadel_Comment.pdf

Both FIMSAC and FINRA have been unable to demonstrate that

(a) block trade liquidity has significantly deteriorated in recent years, and

(b) any such deterioration is directly attributable to the current post-trade transparency framework.

As a result, there is little evidence to suggest that the Proposed Pilot will meaningfully improve liquidity conditions. Instead, the costs and complexity of the Proposed Pilot significantly outweigh the asserted benefits, as it will negatively impact a wide range of market participants, including retail and institutional investors, smaller liquidity providers, new electronic trading platforms, and investors in correlated products, such as ETFs. We urge FINRA to instead focus on market structure initiatives that are designed to increase liquidity by making the corporate bond markets more fair, open, competitive, and transparent.