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**SEC STAFF REPORT ON THE SECOND YEAR OF THE  
FIXED INCOME MARKET STRUCTURE ADVISORY COMMITTEE**

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March 2, 2020

This is a report of the staff of the U.S. Securities and Exchange Commission.

The Commission has expressed no view regarding the analysis, findings, or conclusions contained in this report.

## Introduction

The staff of the U.S. Securities and Exchange Commission (the “Commission”) prepared this report to provide the public with a summary of the activities of the Fixed Income Market Structure Advisory Committee (“FIMSAC” or the “committee”) since the 2018 FIMSAC Annual Report.<sup>1</sup>

The FIMSAC was formed in November 2017 to provide the Commission with diverse perspectives on the structure and operations of the U.S. fixed income markets, as well as advice and recommendations on matters related to fixed income market structure.<sup>2</sup> The FIMSAC’s initial focus is to provide advice to the Commission on the efficiency and resiliency of the corporate bond and municipal securities markets and to identify opportunities for regulatory improvements. The FIMSAC was renewed for a one-year term that expires on November 13, 2020.<sup>3</sup>

The committee comprises 23 members: 21 voting members and 2 non-voting members. The two non-voting members represent the Financial Industry Regulatory Authority (“FINRA”) and the Municipal Securities Rulemaking Board (“MSRB”). The membership includes individuals representing a range of perspectives on the fixed income markets including retail and institutional investors, corporate and municipal issuers, trading venues, bank and non-bank affiliated institutional dealers, a retail dealer, a regional municipal securities dealer, a proprietary trading firm, a data provider, academics, and self-regulatory organizations.<sup>4</sup>

The FIMSAC held four public meetings in 2019, which focused on a range of issues. In 2019, the FIMSAC made 5 recommendations to the Commission, which are described below.<sup>5</sup> The FIMSAC currently has five subcommittees: (1) Corporate Bond Transparency, (2) Municipal Securities Transparency, (3) ETFs and Bond Funds, (4) Technology and Electronic Trading, and (5) Credit Ratings.<sup>6</sup>

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<sup>1</sup> The 2018 FIMSAC Annual Report is available at: <https://www.sec.gov/spotlight/fixed-income-advisory-committee/fimsac-report-2018.pdf>.

<sup>2</sup> The FIMSAC’s current charter is available at: <https://www.sec.gov/spotlight/fixed-income-advisory-committee/fimsac-charter-nov-2019.pdf>.

<sup>3</sup> Notice of the FIMSAC’s renewal is available at: <https://www.sec.gov/rules/other/2019/34-87482.pdf>.

<sup>4</sup> A list of the FIMSAC’s current members is available at: <https://www.sec.gov/spotlight/fixed-income-advisory-committee>.

<sup>5</sup> As of December 31, 2019, the FIMSAC has held eight public meetings and numerous subcommittee meetings, and has made ten recommendations on nine topics. *See id.*

<sup>6</sup> Information concerning the subcommittees, including their membership and summary minutes of each subcommittee meeting is available at: <https://www.sec.gov/spotlight/fixed-income-advisory-committee/fixed-income-market-structure-advisory-committee-subcommittees.htm>. Subcommittee meetings, held via conference call, are not open to the public. These subcommittee meetings may include, by invitation, non-committee members.

## Update on the Work of the Corporate Bond Transparency Subcommittee

The Corporate Bond Transparency subcommittee is tasked with considering the impacts of transparency, both pre-trade and post-trade, on the corporate bond market. The subcommittee is charged with reviewing the current transparency regimes for this market and identifying methods for analyzing whether they are optimally serving the market. With respect to post-trade transparency, topics that may be considered include a review of the current reporting and dissemination framework, its impact on market liquidity and any adjustments that may be advisable, as well as potential enhancements that may improve the quality and usefulness of the reported information. With respect to pre-trade transparency, topics that may be considered include a review of the availability of pre-trade pricing information to market participants, and whether the corporate bond market, or particular segments thereof, may benefit from the coordinated collection and dissemination of this information.

Throughout 2019, the subcommittee held a number of meetings and invited outside market participants to discuss a range of topics related to corporate bond transparency. In particular, the subcommittee focused on three issues in 2019: (1) potential enhancements to FINRA's Trade Reporting and Compliance Engine ("TRACE") system; (2) retail investor education concerning, and disclosures and sales practices related to, retail notes; and (3) comments submitted in response to FINRA's April 2019 request for comment on a pilot program to assess the impact of trade price dissemination of large-size trades.<sup>7</sup> As discussed further below, the subcommittee's consideration of the retail note market led the subcommittee to present one recommendation to the FIMSAC, which was approved by the FIMSAC.

With respect to potential TRACE enhancements, the subcommittee has discussed the potential for flagging or identifying in TRACE transactions that are executed as part of a large portfolio trade; flagging or identifying transactions in TRACE that are conducted on a spread basis early in the day but not executed until later that day; and reporting transaction prices to TRACE that do not include mark-ups on riskless principal transactions and trading platform transaction fees. The topic of potential TRACE enhancements has also been a topic of consideration for the Technology and Electronic Trading Subcommittee.<sup>8</sup> Concerning FINRA's request for comment, the subcommittee has considered FINRA's proposal and the comments

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<sup>7</sup> See FINRA Regulatory Notice 19-12 (Apr. 12, 2019), available at <https://www.finra.org/rules-guidance/notices/19-12>. The pilot outlined by FINRA was developed in response to FIMSAC's April 2018 recommendation for a pilot program on block-size trades in corporate bonds. See FIMSAC Recommendation for a Pilot Program for Block Size Trades in the Corporate Bond Market (Apr. 9, 2018), available at: <https://www.sec.gov/spotlight/fixed-income-advisory-committee/fimsac-block-trade-recommendation.pdf>.

<sup>8</sup> The FIMSAC approved a recommendation on this topic at the February 10, 2020 meeting: <https://www.sec.gov/spotlight/fixed-income-advisory-committee/fimsac-additional-trace-flags-recommendation.pdf>.

submitted in response to the proposal, as well as possible alternative structures for the pilot that market participants have presented to the subcommittee.

### *Recommendation Regarding Investor Education on Retail Notes*

At the July 29, 2019, meeting, the FIMSAC recommended that the Commission and FINRA educate retail investors on the uses, characteristics, and risks of retail notes, which could be accomplished through issuance of an “Investor Bulletin.”<sup>9</sup> Retail notes are corporate bonds that many issuers sell directly to retail investors. As noted by the FIMSAC, these products often have features designed to appeal to retail investors, such as: (i) regular issuances that are priced at par; (ii) yield enhancements due to a callable feature; and (iii) a survivor option that allows beneficiaries of the original buyer to sell the bond back to the issuer at par following the death of the original buyer.<sup>10</sup> The FIMSAC recommendation presented research demonstrating that secondary market liquidity in retail notes is low, and trading and transaction costs in retail notes are high, by comparison to bonds issued by the same issuer to institutional investors.<sup>11</sup>

In its recommendation to the Commission, the FIMSAC proposed that investors should be informed of the embedded issuer call option and survivor put options that are typical in these notes along with other options that may have an impact on the pricing of these notes. In addition, the FIMSAC believed that investors should be made aware of their lower secondary market liquidity compared to similar securities from the same issuer.<sup>12</sup>

### **Update on the Work of the Municipal Securities Transparency Subcommittee**

The Municipal Securities Transparency subcommittee’s mandate is consistent with that of the Corporate Bond Transparency subcommittee, with the exception that its focus is on the municipal securities market. Throughout 2019, the subcommittee held a number of meetings and invited outside market participants to discuss a range of topics impacting the municipal securities market. These discussions led the subcommittee to present two recommendations to the FIMSAC, both of which the FIMSAC approved and are described below.

In addition to the two recommendations discussed below, the subcommittee focused on (1) the content and timeliness of municipal issuer disclosure,<sup>13</sup> (2) structured disclosures by

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<sup>9</sup> See FIMSAC Recommendation Regarding Investor Education Around Secondary Market Liquidity in the Corporate Bond Market for Retail Notes (July 29, 2019), available at <https://www.sec.gov/spotlight/fixed-income-advisory-committee/corporate-bond-transparency-subcommittee-prelim-072919.pdf>.

<sup>10</sup> See *id.*

<sup>11</sup> See *id.*

<sup>12</sup> See *id.*

<sup>13</sup> The FIMSAC approved a recommendation on this topic at the February 10, 2020 meeting: <https://www.sec.gov/spotlight/fixed-income-advisory-committee/fimsac-muni-financial-disclosures-recommendation.pdf>.

municipal issuers, and (3) pre-trade transparency in the municipal securities market. At the July 29, 2019, meeting, the subcommittee, jointly with the Credit Ratings subcommittee, presented a panel to discuss the content and timeliness of municipal issuer disclosures. This panel included a variety of market participants, including an issuer, an analyst, an investor, and a broker-dealer; and discussed various types of information municipal issuers provide to investors and to credit rating agencies, in connection with primary offerings and in the secondary market, the timing of the provision of such information, and how the availability and timing of disclosures affects the market.

Additionally, at the November 4, 2019, meeting, the subcommittee arranged for a panel to discuss the use of structured disclosures (e.g., XBRL) by municipal issuers. This panel included a variety of market participants, including an issuer, an analyst, a structured disclosure professional, and staff from the Commission and the MSRB; and presented a wide-ranging discussion of the potential use of structured disclosure in the municipal market, including the costs and benefits to various market participants, possible uses of structured disclosure by investors and other entities both within and without the securities markets, and potential regulatory paths and hurdles.

Finally, the subcommittee also has decided to examine issues related to the availability of pre-trade data in the municipal securities market in the next year.

*Recommendation Regarding Certain Principal Transactions with Advisory Clients in Negotiated Municipal Underwritings*

At the April 15, 2019, meeting, the FIMSAC recommended that the Commission consider a rule that permits a broker-dealer that negotiates and underwrites a new-issue municipal bond or is a co-manager or member of the selling group to meet the requirements of section 206(3) of the Investment Advisers Act (the “Advisers Act”) more easily when acting in a principal capacity to sell new-issue municipal bonds during the negotiated order period.<sup>14</sup> As noted by the FIMSAC, currently a broker-dealer cannot offer or sell negotiated new issue bonds to an advisory client of the broker-dealer’s affiliated investment adviser without meeting the disclosure and consent requirements of the Advisers Act.<sup>15</sup> According to the FIMSAC, this

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<sup>14</sup> See FIMSAC Recommendation Regarding Principal Transactions with Advisory Clients in Negotiated Municipal Underwritings (Apr. 15, 2019), available at: <https://www.sec.gov/spotlight/fixed-income-advisory-committee/fimsac-negotiated-municipal-underwritings-recommendations.pdf>

<sup>15</sup> *Id.* at p. 1 (“As background, section 206(3) of the Advisers Act makes it unlawful for any investment adviser, directly or indirectly, “acting as principal for his/her own account, knowingly to sell any security to or purchase any security from a client, without disclosing to such client in writing before the completion of such transaction the capacity in which he/she is acting and obtaining the consent of the client to such transaction.” The disclosure and consent is required on a transaction-by-transaction basis.”)

could cause a client to not have access to new issue bonds that meet their investment criteria or only have access to bonds in the secondary market at potentially higher prices.

*Recommendation Regarding Certain Principal Transactions with Advisory Clients Seeking to Liquidate Bond Positions*

At the July 29, 2019, meeting, the FIMSAC recommended that the Commission consider a rule that permits a broker-dealer to meet the requirements of section 206(3) of the Advisers Act more easily when acting in a principal capacity to sell certain client bond positions within the normal liquidation process, by allowing dealers to submit a “blind bid” to trade with its advisory clients on a principal basis.<sup>16</sup> This recommendation was made after a preliminary recommendation was presented by the subcommittee at the April 15, 2019, FIMSAC meeting on the same topic. As noted by the FIMSAC, a broker-dealer is not permitted to enter a bid for the broker-dealer’s own account to purchase a bond in an advisory account of the broker-dealer’s affiliated investment adviser without complying with the disclosure and consent requirements of the Advisers Act.<sup>17</sup> According to the FIMSAC, this could cause a client in an advisory account to receive a less favorable price, especially during volatile markets.

**Update on the Work of the ETFs and Bond Funds Subcommittee**

The ETFs and Bond Funds subcommittee was created to consider the impacts of the growth of registered funds, including both ETFs and open-end mutual funds, as investors in the corporate and municipal bond markets. In particular, it was charged with assessing the consequences of the increased presence of fixed income mutual funds and ETFs in these markets, including their current and possible future impacts on the liquidity and pricing of the underlying bonds under a variety of scenarios, as well as investor understanding of these products.

The subcommittee met several times over the course of the year and focused its attention on three topics.<sup>18</sup> The first was the operation of bond funds and ETFs in periods of market stress. At the FIMSAC meeting on April 15, 2019, the subcommittee presented a related report.<sup>19</sup> The second and third topics focused on the role of authorized participants and the impact of bond index construction on managed bond portfolios. At the FIMSAC meeting on July 29, 2019, the subcommittee identified these as two potential panel topics for a future

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<sup>16</sup> See FIMSAC Recommendation Regarding Principal Transactions with Advisory Clients Selling Municipal Securities (July 29, 2019), available at: <https://www.sec.gov/spotlight/fixed-income-advisory-committee/fimsac-recommendation-muni-securities.pdf>

<sup>17</sup> See parenthetical n. 15, *supra*.

<sup>18</sup> See note 4 above regarding summary minutes of each subcommittee meeting.

<sup>19</sup> See Report on the Design of Exchange-Traded Funds and Bond Funds – Implications for Fund Investors and Underlying Security Markets Under Stressful Conditions (Apr. 10, 2019), available at: <https://www.sec.gov/spotlight/fixed-income-advisory-committee/etfs-and-bond-funds-subcommittee-report-041519.pdf>.

FIMSAC meeting.<sup>20</sup> At the FIMSAC meeting on November 4, 2019, the subcommittee presented a panel discussing fixed income index construction, with panelists from the industry and academia.

### **Update on the Work of the Technology and Electronic Trading Subcommittee**

The Technology and Electronic Trading subcommittee was formed to consider the impact of the growth of electronic trading platforms and the increased use of other electronic systems on the liquidity, efficiency and resiliency of the corporate and municipal bond markets. Throughout 2019, the subcommittee held a number of meetings and invited outside market participants to discuss a range of topics that impact electronic trading. These discussions led the subcommittee to present two recommendations to the FIMSAC, both of which the FIMSAC approved.

In addition to the two recommendations, the subcommittee engaged in discussions on a variety of topics including matters concerning the clearance and settlement system and how it may affect all-to-all trading, the corporate bond gray market, cybersecurity issues in the municipal securities market, and best execution. As noted above, the subcommittee has also explored potential TRACE and MSRB reporting enhancements, including (1) flagging or identifying transactions that are executed as part of a portfolio trade; (2) flagging or identifying transactions that are conducted on a spread basis to U.S. Treasury securities early in the day but not executed until later that day; and (3) establishing a standard definition of an electronic trade that would be used by all electronic trading venues to identify transactions occurring on such venues.<sup>21</sup> Finally, the subcommittee is examining the ability of a registered fund to engage in purchases and sales of securities with another fund managed by the same investment adviser, and is considering whether a recommendation on this topic is warranted.

#### *Recommendation Regarding the Practice of Pennyning in the Corporate and Municipal Bond Markets*

At the June 11, 2019, meeting, the FIMSAC recommended that the Commission take several actions to address the use of “pennyning” in the corporate and municipal bond markets.<sup>22</sup> The FIMSAC defined pennyning to occur when a dealer, after reviewing price information received in a bid-wanted or offer-wanted auction, internalizes its customer’s order by either matching the auction’s best price or executing the order at a price that is slightly better than the auction’s best price. The FIMSAC stated that it believed this practice harms the competitiveness of bid-wanted and offer-wanted auctions. The FIMSAC recognized that the MSRB had

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<sup>20</sup> See July 29, 2019 FIMSAC Transcript of Meeting, pp. 106-09, available at: <https://www.sec.gov/spotlight/fixed-income-advisory-committee/fimsac-072919transcript.txt>.

<sup>21</sup> See *supra* note 8.

<sup>22</sup> See FIMSAC Recommendation Regarding the Practice of Pennyning in the Corporate and Municipal Bond Markets (Jun. 11, 2019), available at: <https://www.sec.gov/spotlight/fixed-income-advisory-committee/fimsac-pennyning-recommendations.pdf>.

previously published a Request for Comment on Draft Interpretive Guidance on Pennying in the municipal securities market<sup>23</sup> and recommended that the Commission encourage FINRA to publish a request for comment on the use of pennyning in the corporate bond market. The FIMSAC recommendation, among other things, further called for the Commission to encourage FINRA and the MSRB to coordinate their final responses on this issue.

*Recommendation Regarding a FINRA Proposal to Establish a Corporate Bond New Issue Reference Data Service*

At the June 11, 2019, meeting, the FIMSAC recommended that the Commission approve a FINRA proposed rule change to establish a corporate bond new issue reference data service.<sup>24</sup> The FIMSAC previously recommended the creation of a centralized and widely accessible database containing specific data elements for newly issued corporate bonds that it believed would make the valuation, trading, settlement, and trade reporting of these bonds more efficient.<sup>25</sup> On March 27, 2019, FINRA filed a proposed rule change with the Commission that would implement that prior recommendation by establishing a central depository for public dissemination of new issue corporate bond reference data.<sup>26</sup> The June 11, 2019, FIMSAC recommendation, also submitted as a comment letter on the FINRA proposed rule change,<sup>27</sup> substantiated the inclusion of the data fields FINRA proposed that the FIMSAC believed would serve the stated purpose of making the valuation, trading, settlement, and trade reporting of new issue corporate bonds more efficient. In addition, FIMSAC recommended the inclusion of several other data fields that it believed also served this purpose. In its comment letter, the FIMSAC also stated that it believed FINRA was the most appropriate entity to operate a corporate bond new issue reference database because it would be an impartial operator that

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<sup>23</sup> See MSRB Regulatory Notice 2018-22 (Sept. 7, 2018), available at: <http://www.msrb.org/~media/Files/Regulatory-Notices/RFCs/2018-22.ashx??n=1>.

<sup>24</sup> See FIMSAC Recommendation Regarding FINRA Proposal to Establish a Corporate Bond New Issue Reference Data Service (Jun. 11, 2019), available at: <https://www.sec.gov/spotlight/fixed-income-advisory-committee/fimsac-comment-letter-new-issue-reference-data-service.pdf>.

<sup>25</sup> See FIMSAC Recommendation to Establish a New Issue Reference Data Service for Corporate Bonds (Oct. 29, 2018), available at: <https://www.sec.gov/spotlight/fixed-income-advisory-committee/fimsac-corporate-bond-new-issue-reference-data-recommendation.pdf>.

<sup>26</sup> See Securities Exchange Act Release No. 85488 (Apr. 2, 2019), 84 FR 13977 (Apr. 8, 2019) (SR-FINRA-2019-008). This FINRA proposal was approved via delegated authority on December 4, 2019: <https://www.sec.gov/rules/sro/finra/2019/34-87656.pdf>. The Commission then received a notice of intention to petition for review of the delegated action, pursuant to Rule 430 of the Commission's Rules of Practice, 17 CFR 201.430. This notice stayed the Commission's delegated action. On December 18, 2019, Bloomberg filed a petition for review: <https://www.sec.gov/rules/sro/finra/2019/34-87656-petition-for-review.pdf>.

<sup>27</sup> See *supra* note 24.

would be required to provide the corporate bond new issue reference data to all market participants on objective and non-discriminatory terms.

## Update on the Work of the Credit Ratings Subcommittee

In February 2019, the Credit Ratings subcommittee was established to consider the role of credit ratings in the corporate bond and municipal securities markets, in response to a panel presented at the FIMSAC's October 29, 2018 meeting entitled *Corporate Credit Markets: The Role of Credit Ratings in a Higher Leverage World*. The subcommittee may consider the following topics: (1) the use of credit ratings by various market participants and the implications of ratings changes for these market participants; (2) the costs and benefits of the current model for credit rating issuance; (3) the U.S. regulatory regime for credit rating agencies registered as nationally recognized statistical rating organizations ("NRSROs"); and (4) issuances of unsolicited credit ratings and the publication of commentaries.

The Credit Ratings subcommittee has met several times since February 2019 and has heard from certain NRSROs, investors, issuers, academics, and other market participants on the above topics. Commission staff has shared information with the subcommittee on the current regulatory regime for NRSROs, as well as on certain studies and reports produced by Commission staff and by the U.S. Government Accountability Office, or GAO.<sup>28</sup>

At the FIMSAC meeting on July 29, 2019, the Credit Ratings subcommittee presented a panel entitled *Credit Ratings: Future Modifications or Status Quo* that included representatives from corporate bond issuers and NRSROs.<sup>29</sup> The discussion centered on NRSRO competition and NRSRO compensation models. Following the meeting, the subcommittee focused its efforts on further exploring alternative NRSRO compensation models.

At the FIMSAC meeting on November 4, 2019, the Credit Ratings subcommittee presented a panel on *Alternative Compensation Models for Credit Rating Agencies* that included authors of certain models.<sup>30</sup> The purpose of the discussion was to present the information to the FIMSAC and to update the FIMSAC on the subcommittee's ongoing work in this area. The subcommittee continues to assess these issues.

## Future Areas of Interest for FIMSAC

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<sup>28</sup> See GAO Report to Congressional Committees: Action Needed to Improve Rating Agency Registration Program and Performance-Related Disclosures (Sept. 2010), available at <https://www.gao.gov/assets/310/309849.pdf>; GAO Report to Congressional Committees: Alternative Compensation Models for Nationally Recognized Statistical Rating Organizations (Jan. 2012), available at <https://www.gao.gov/assets/590/587832.pdf>; SEC staff Report to Congress on Assigned Credit Ratings (Dec. 2012), available at <https://www.sec.gov/news/studies/2012/assigned-credit-ratings-study.pdf>.

<sup>29</sup> See July 29, 2019 FIMSAC Agenda, available at: <https://www.sec.gov/spotlight/fixed-income-advisory-committee/agenda-072919.htm>.

<sup>30</sup> See November 4, 2019 FIMSAC Agenda, available at: <https://www.sec.gov/spotlight/fixed-income-advisory-committee/fimsac-agenda-110419.htm>.

The FIMSAC subcommittees continue to assess various issues. The Municipal Securities Transparency subcommittee continues to review pre-trade transparency. The Corporate Bond Transparency subcommittee is evaluating comments on the FINRA pilot framework. The Credit Ratings subcommittee continues to evaluate the issuer-pay model for credit ratings. The Technology and Electronic Trading subcommittee is examining the ability of a registered fund to engage in purchases and sales with another fund managed by the same investment adviser.

In addition, the FIMSAC is considering a request from Chairman Clayton to devote attention to and provide information regarding the status and functioning of the fixed income capital markets generally at meetings in 2020. The analysis and commentary may address various structural and macroeconomic factors, including, without limitation: (1) developments in monetary policy and corresponding financial conditions as they relate to the fixed income markets; (2) the transition away from LIBOR; (3) developments in the sub-investment grade and leveraged finance markets, including covenant packages; and (4) developments in the municipal finance markets, including issuer disclosure.

## **Conclusion**

This report summarizes the activities of the FIMSAC in 2019. The FIMSAC continues to pursue a variety of initiatives concerning the market structure for corporate bonds and municipal securities. Information regarding the FIMSAC's work is available on the Commission's website at <https://www.sec.gov/spotlight/fixed-income-advisory-committee>. The FIMSAC will also hold public meetings in 2020, and these meetings will be webcast to the public on the Commission's website. The FIMSAC held a meeting on February 10, 2020 and, while subject to change, the FIMSAC's remaining meetings for 2020 currently are scheduled for April 27 and August 3.