June 11, 2019

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006
Via Electronic Filing

Re: Regulatory Notice 19-12; Proposed Pilot Program to Study Recommended Changes to Corporate Bond Block Trade Dissemination

Dear Ms. Asquith,

We appreciate the opportunity to provide our views and observations on the Financial Industry Regulatory Authority ("FINRA") Proposed Pilot Program to Study Recommended Changes to Corporate Bond Block Trade Dissemination ("Proposed Pilot"). The Proposed Pilot stems from the work of the Securities and Exchange Commission's ("SEC") Fixed Income Market Structure Advisory Committee ("FIMSAC"), which recommended a pilot on this topic in April 2018 ("FIMSAC Recommendation").[1] The FIMSAC Recommendation generated a great deal of debate, including dissenting votes from FIMSAC members,[2] and we are pleased to add our voice to the discussion around the resulting Proposed Pilot.

AQR is a global asset management firm based in Greenwich, Connecticut and as of March 31, 2019 has approximately $203 billion in assets under management across both long-only and alternative investment strategies. AQR has invested in fixed income markets since the firm's inception over twenty years ago and manages funds that invest in both investment grade and high yield corporate bonds.

Given our role in the market, we become concerned about any efforts to undo transparency for corporate bonds and the benefits that it provides. The benefits of transparency are well-documented. For example, academic research cited in the Proposed Pilot shows that the transparency afforded by the Trade Reporting and Compliance Engine ("TRACE") has reduced transaction costs for both retail and institutional investors. We believe that reduced transaction costs are but one of the many market-wide

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[1] *See* Recommendation for a Pilot Program to Study the Market Implications of Changing the Reporting Regime for Block-Size Trades in Corporate Bonds (Apr. 9, 2018), *available at* https://www.sec.gov/spotlight/fixed-income-advisory-committee/fimsac-block-trade-recommendation.pdf.

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

benefits of transparency undermined by the Proposed Pilot, and as a result we cannot support this initiative. However, we recognize that FINRA may feel obligated to move forward despite the concerns raised by AQR and many other commenters. Should the Proposed Pilot proceed, we believe that key changes would be necessary to improve its effectiveness.

The Proposed Pilot Should Not Proceed

The Proposed Pilot represents a thoughtful attempt by FINRA to improve on the FIMSAC Recommendation. Yet despite this good work, we believe that FINRA should not proceed with the pilot program because its focus is misdirected and it may have a detrimental impact on the market.

Misdirected Focus

While we are strong supporters of making policy decisions based on the type of data-driven analysis afforded by pilot programs, the reality is that all pilots are disruptive to the workflow of market participants and thus have inherent costs. In order to justify imposing such costs on the marketplace as a whole there should be clear evidence that the changes being tested have at least a reasonable likelihood of achieving the desired outcome. We do not believe that the Proposed Pilot meets this basic standard.

The notion of a pilot designed to benefit block trades developed out of a broader FIMSAC discussion around the current liquidity conditions in the fixed income market. As FINRA notes in the Proposed Pilot, "[a]n implicit assumption of the FIMSAC Recommendation is that an increase in the size or frequency of block trades or improved ability for dealers to manage inventory risk associated with block trades will improve fixed income market quality." This statement highlights a key problem with the Proposed Pilot: a lack of any clear evidence that increasing block trades will improve overall bond market quality or liquidity.

The Proposed Pilot, and the FIMSAC Recommendation before it, are both supported primarily by anecdotes from a small number of market participants that large block-sized trades are challenging to execute. These market participants then theorize that if transparency is reduced in ways that benefit block trades then the underlying liquidity in the market will increase. Despite these anecdotal assertions, we are not aware of any data-driven analysis supporting the argument that reducing transparency in line with the Proposed Pilot is likely to achieve the desired goal of enhanced overall market liquidity. However, academic research studying the impact of publicly disseminated pricing information through TRACE does reinforce the conclusion that TRACE transparency benefits overall corporate bond market quality.[3] When analyzing the arguments for and against the Proposed Pilot based on existing evidence we are reminded of the aphorism, *"The plural of anecdote is not data."*

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[3] *See, e.g.*, Bessembinder, Maxwell and Venkataraman, *Market Transparency, Liquidity Externalities, and Institutional Trading Costs in Corporate Bonds* (2006), Edwards, Harris and Piwowar, *Corporate Bond Market Transaction Costs and Transparency* (2007), and Goldstein, Hotchkiss and Sirri, *Transparency and Liquidity: A Controlled Experiment on Corporate Bonds* (2007).

The evidence we do see for the decrease in bond market liquidity points to reduced dealer inventory and capital commitment in a market structure reliant on a small number of large dealers.[4] These reductions are commonly attributed to post-financial crisis regulatory reform, including bank capital requirements and the Volcker Rule. Yet the Proposed Pilot looks past this evidence and instead seeks to address concerns about bond market liquidity by limiting post-trade transparency. We do not believe sufficient justification exists for adopting this pilot, particularly given the large body of published research evidencing the benefits of transparency.

Potential Negative Market Impacts

Not only is the focus of the Proposed Pilot misdirected, but it has the potential to negatively impact the market as a whole and the majority of market participants.

The Proposed Pilot is designed to allow market participants entering into block-sized trades to conceal these transactions from the rest of the market during the 48-hour dissemination delay. The delay would allow these market participants to more easily offset the risk of large transactions into the market. While market participants frequently entering into block trades will clearly benefit the most from the Proposed Pilot's 48-hour delay, it is just as clear that this benefit comes at a cost to the rest of the market. In fact, FINRA identified precisely this point when suggesting that the Proposed Pilot "…may effectively represent a risk transfer between [ ] dealers and the ultimate holders of the securities." Thus the most direct result of the Proposed Pilot is to reduce transparency in ways that benefit the small number of participants who engage in block trades, both dealers and buy side, to the detriment of all other market participants.

In addition to reducing transparency in ways that negatively impact most market participants, adopting the Proposed Pilot may change the behaviour of market participants in ways that would further erode market-wide transparency and as a result, overall liquidity. For example, by providing informational advantages to those transacting in block-sized trades, we expect that the Proposed Pilot may succeed in increasing the volume of block transactions. However, if this increased block volume results from market participants shifting their execution strategies to preference executing block trades where they otherwise would have entered into a series of smaller transactions, overall volume and risk transfer in the market would be the same, but at the cost of market-wide transparency.

Finally, the Proposed Pilot may result in the dissemination of misleading information into the market. This problematic potential result is evident through the example of a buy side participant working a large sell order, at a size above the block threshold, through a dealer under the Proposed Pilot. The seller's trade could be booked as a single transaction at the aggregate size, which would not be disseminated until 48 hours after the transaction. The dealer in this scenario may unwind the risk of that transaction in smaller pieces, in sizes under the block threshold, which would be disseminated without delay. This set of trades would result in a distorted view of current market conditions because for 48 hours after the transaction TRACE data would suggest that there was net buying interest in the market

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[4] *See, e.g.*, Bessembinder, Jacobsen, Maxwell and Venkataraman, *Capital Commitment and Illiquidity in Corporate Bonds* (2017).

when in fact that was not the case. The distorted view of the market highlighted by this example illustrates the asymmetric informational advantage non-dissemination conveys to the participants in the block trade at the expense of all other market participants.

For these reasons, we do not believe that the potential benefits of the Proposed Pilot justify the risks for negative impacts it would introduce through changes to the current market structure.

Recommendations for Modifying the Proposed Pilot

Despite our opposition to the Proposed Pilot we commend FINRA for its work, which vastly improves on the initial FIMSAC Recommendation. The most important improvement made by FINRA is the inclusion of a control group to ensure that there is a baseline against which the data collected in the pilot can be measured. We believe this key change better allows for a meaningful data-driven review of the impact of potential changes to the current fixed income transparency regime.

We recognize that FINRA may determine that it is necessary to proceed with a pilot given the FIMSAC Recommendation and longstanding anecdotal claims that certain block trades in corporate bonds are not being executed under the current market structure. If that is indeed the path that FINRA chooses, we offer the following recommendations for improving the pilot.

Raise Dissemination Thresholds

The Proposed Pilot, like the FIMSAC Recommendation, would raise the current dissemination caps from $5 million to $10 million for investment grade corporate bonds, and from $1 million to $5 million for non-investment grade corporate bonds. These changes move the dissemination caps in a positive direction, but not nearly far enough if the goal is to address liquidity conditions for block trades.

In our experience, bond trades at or above those thresholds happen on a regular basis without extreme difficulty or outsized market impact. Based on FIMSAC's analysis of historical volumes from 2013 to 2017, over 32% of investment grade volume was transacted in trades larger than $10 million and over 40% of high yield volume was transacted in trades larger than $5 million. To change dissemination of trade information for approximately a third or more of the volume traded in the market would be a substantial – and in our view unacceptable – reduction in transparency benefiting only the participants of those transactions at the expense of the rest of the marketplace.

Consider how this reduction in transparency could change the perspective of a market participant who is evaluating the economic viability of providing liquidity in high yield bonds. If that market participant knows that 40% of the volume in these bonds is not being disseminated for at least two days, such lack of information would clearly serve as a deterrent to entering the market. This hinderance to liquidity provision will be exacerbated by the fact that we expect the Proposed Pilot to further increase the volume of trades above the thresholds given the benefits that would accrue from the 48-hour delay. Thus the 32% of investment grade and 40% of high yield volume cited by FIMSAC should be seen as lower bounds for how much volume would actually be non-disclosed under the Proposed Pilot rather than fair estimates of the lack of transparency that would result.

We strongly encourage FINRA to substantially raise the dissemination thresholds if it moves forward with the Proposed Pilot to both better reflect market realities for large corporate bond block trades and prevent a severe loss of transparency for a significant portion of corporate bond volume.

Reduce Dissemination Delay for Uncapped Trades

The Proposed Pilot would reduce transparency in the corporate bond market to the detriment of the market as a whole. Given the negative impacts this initiative will have on many market participants, we suggest that FINRA balance it by providing additional transparency to the full, uncapped historical datasets for these transactions.

Significant benefits accrue solely from understanding volumes trading in the market. As an example, for portfolio managers who are concerned about the liquidity of their position, there are benefits to sizing positions based on more recent actual trading data. From a risk management perspective, having a more accurate estimate of liquidity will allow these portfolio managers to more effectively set position limits in funds.

The Proposed Pilot would provide data on uncapped transactions six months after the calendar quarter in which they are reported, consistent with current practice. We believe that this delay is far too long and that a significant reduction in this delay would not negatively impact a dealer's ability to unwind block trades, while adding back a level of transparency that would benefit the non-dealer market participants who are being disadvantaged by the Proposed Pilot. The FIMSAC Recommendation suggested reducing this delay to 3 months, and we believe that it could be reduced even further without negatively impacting any market participants.

Conclusion

The Proposed Pilot raises a number of very important topics within fixed income market structure and we commend FINRA for its work to improve upon the FIMSAC Recommendation and obtain industry feedback on the initiative. Given the strong opinions both for and against the FIMSAC Recommendation, obtaining input from a diverse set of market participants is imperative in determining the path forward.

Our views on the Proposed Pilot are colored both by our belief in the benefits of transparency and concerns about its potentially detrimental impacts. In addition to these views, we believe that the Proposed Pilot should be reviewed within the context of the evolving nature of the fixed income markets. These markets are dynamically adjusting to competitive forces and developing technology in exciting ways, such as the movement towards electronic markets and the transparency, liquidity, trading functionality, and pricing benefits that they provide. These changes broadly benefit the market and pave the way for more diversified and resilient bond markets in ways that allow more participants to add liquidity and fill in gaps left by a decrease in capital commitment by traditional dealers.

We support regulatory efforts aimed at developing a 21st century fixed income market structure reflecting these advances. Unfortunately, the Proposed Pilot does the opposite, by encouraging a reversion to the market structure of the past rather than preparing our markets for the future. We respectfully suggest that FINRA not move forward with the Proposed Pilot and instead focus its efforts and those of the industry in the direction of enhancing overall corporate bond market liquidity by reducing barriers to entry and encouraging increased liquidity provision from a broad range of market participants.

Please feel free to contact us with any questions concerning these comments at Isaac.Chang@aqr.com or Richard.Grant@aqr.com.

Sincerely,

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