HEALTHY MARKETS
TRANSPARENCY & TRUST

June 6, 2019

Via Electronic Mail (pubcom@finra.org)

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Re: Regulatory Notice 19-12, FINRA Requests Comment on a Proposed Pilot Program to Study Recommended Changes to Corporate Bond Block Trade Dissemination

Dear Ms. Asquith:

Healthy Markets Association[1] appreciates the opportunity to comment on the above-referenced proposal to adopt a pilot program for delaying reporting of "block" trades in corporate bonds for 48 hours.[2]

We begin by commending FINRA and the SEC's Fixed Income Market Structure Advisory Committee (FIMSAC) for looking for ways to improve trading in corporate debt securities. However, we are concerned that the proposal would run counter to improving the market for investors. Accordingly, we respectfully urge you to abandon the proposed pilot program.

The FINRA Proposal does offer one potential bright spot for investors--increased transparency for investment grade trades of between $5 and $10 million, and for non-investment grade trades between $1 and $5 million. In this regard, we urge FINRA to seek comments, review studies, and consider eliminating the delayed public dissemination of details for such trades.

Background on Current Corporate Bond Reporting

[1] The Healthy Markets Association is an investor-focused not-for-profit coalition working to educate market participants and promote data-driven reforms to market structure challenges. Our members, who range from a few billion to hundreds of billions of dollars in assets under management, have come together behind one basic principle: Informed investors and policymakers are essential for healthy capital markets. To learn more about Healthy Markets or our members, please see our website at http://healthymarkets.org.

[2] FINRA, *Trade Reporting and Compliance Engine (TRACE): FINRA Requests Comment on a Proposed Pilot Program to Study Recommended Changes to Corporate Bond Block Trade Dissemination*, Regulatory Notice 19-12, (Apr. 2019), *available at* https://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-19-12.pdf.

The FINRA TRACE collects and disseminates upon receipt by FINRA secondary market trading activity in corporate bonds and other debt securities that are registered, as well as those that are not registered pursuant to 144A.[3] In general, FINRA requires reporting of all secondary market trades within 15 minutes, but if the amounts are above $5mm in IG or $1mm in non-IG, then the exact size is left out of the immediately disseminated reports. The exact sizes of these larger dollar trades are made available 6 months later.

About the FINRA Proposal

On April 12, 2019, FINRA proposed a pilot that would be comprised of three test groups and a control group. :

The three test groups are:

- Test Group 1, which would study a 48-hour dissemination delay with no change to the current dissemination caps. In other words, for bonds in this test group, TRACE would apply a 48-hour dissemination delay to trades above $5 million in IG corporate bonds, and trades above $1 million in non-IG corporate bonds.
- Test Group 2, which would study increased dissemination caps with no change to the current dissemination timeframes. In other words, for bonds in this test group, TRACE would increase dissemination caps to $10 million for IG corporate bond trades and $5 million for non-IG corporate bonds trades, without applying a 48-hour dissemination delay.
- Test Group 3, which would study both a 48-hour dissemination delay and increased dissemination caps. In other words, for bonds in this test group, TRACE would apply a 48-hour dissemination delay to trades above $10 million in IG corporate bonds, and trades above $5 million in non-IG corporate bonds.[4]

Bonds would be stratified along the characteristics of bond issue size, age of bond issue, bond rating and 144A status.[5]

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[3] Proposal, at 2 (citing FINRA, Notice to Members 01-18 (Mar. 2001), FINRA, Notice to Members 03-12 (Feb. 2003), FINRA, Notice to Members 06-01 (Jan. 2006), and FINRA, Regulatory Notice 13-35 (Oct. 2013)).
[4] FINRA Proposal, at 12.
[5] FINRA Proposal, at 12.

Background and the Genesis of the FINRA Proposal

The FINRA Proposal arises directly from a recommendation from the FIMSAC. In April 2018, the FIMSAC recommended that FINRA adopt a one-year long pilot program that would include two key changes to corporate bond TRACE reporting.[6]

First, the pilot would increase the reporting size caps to $10 million for investment grade bonds and $5 million for non-investment grade bonds. This change would increase transparency, as the exact dollars of trades between $5-$10 million for investment grade trades and $1-$5 million for non-investment grade trades would be disseminated immediately upon receipt.

Second, under the pilot, trades at or above the caps would no longer need to be reported to TRACE for 48 hours. For these trades, most market participants and regulators would not be aware of any elements of the trade during the delay, whereas they currently would be aware of the trade and most material aspects, with the exception of the total size of the trade, within 15 minutes. Thus, the proposal would dramatically decrease transparency for trades above the size caps.

We note that the three-page FIMSAC Recommendation did not include a control group.[7]

While the FIMSAC Recommendation offered little justification, data,[8] or relevant analysis, some commenters explained that the current regime of near-immediate reporting of large block trades leaves dealers with significant risks when engaging in such trades. As JPMorgan Chase explained:

> Providers of liquidity accept heightened risk when transacting in block trades, and these trades are immediately disclosed to the market with masked trade sizes. We believe as a result of this immediate disclosure, broker dealers now prefer smaller trade sizes on average, particularly for less liquid and lower rated bonds. This changes the risk/reward for the broker dealers and is reflected in their pricing. Similarly, we observe that asset managers at times can experience challenges in transacting large trade sizes. We believe that it is important to study whether increases in the delay of public disclosure for block trades, as well as in the dissemination caps, would support larger trade sizes and

[6] FIMSAC, *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 ("FIMSAC Recommendation").
[7] Id.
[8] While not offering any data on the impact or scope of the proposal, the FIMSAC Recommendation did include two pages of high-level summaries of existing trade size characteristics. Id.

> tighter pricing, which would make the market more effective and be beneficial to market participants.[9]

Of course, spreads in the corporate bond markets have tightened in recent years.[10] While average trade sizes and the proportion of corporate bond trades completed in large blocks has arguably decreased,[11] we might note that those changes are, much like trading in other asset classes, likely the result of increased transparency, and electronic trading strategies.

We also note that the FIMSAC Recommendation was highly controversial, and divided the members. Three FIMSAC members, Former SEC Chief Economist Larry Harris, market structure academic Kumar Venkataraman, and former SEC Commissioner Elisse Walter, offered a full-throated dissent to the delayed reporting of large trade information.[12] Subsequent to the recommendation, an association of large fixed income investors[13] and Vanguard[14] also objected to the FIMSAC's recommended 48 hour delay in large trade reporting.

As an initial matter, FINRA proposes changing the embargo publication period of the full uncapped size of trades from the current six months after the calendar quarter in which they are reported to three months. This change is required in order for academics, investors and market participants to independent assess the impacts noted above. We are also supportive of the increase in the dissemination caps. This part of the proposal is not terribly controversial. As Greenwich Associates has recently noted, "[t]he majority of banks and investors we've spoken with over the past few weeks believe this extra level of transparency makes sense in today's market."[15] We advocate FINRA simply raising the dissemination caps.

General Concerns with the FINRA Proposal

The FINRA Proposal to delay the dissemination of "block trades" gives rise to several general concerns, including that it would:

(1) Have a discriminatory impact on market participants and misuse of inside information;

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[9] Letter from Sandra E. O'Conner, JPMorgan Chase, to Brent J. Fields, SEC, June 29, 2018, *available at* https://www.sec.gov/comments/265-30/26530-3974442-167144.pdf ("JPMorgan Chase Letter").
[10] *See, e.g.*, JPMorgan Chase Letter, at 3.
[11] We note that a less than 2% change over several years may not be statistically significant.
[12] Letter from Larry Harris, Kumar Venkataraman, and Hon. Elisse Walter, to Brent J. Fields, SEC, Aug. 21, 2018, *available at* https://www.sec.gov/comments/265-30/26530-4268151-173129.pdf ("FIMSAC Dissenters Letter").
[13] Letter from Cathy Scott, The Credit Roundtable, to Brent J. Fields, SEC, Nov. 27, 2018, *available at* https://www.sec.gov/comments/265-30/26530-4686452-176587.pdf.
[14] Letter from Gregory Davis, Vanguard, to Brent J. Fields, SEC, Jan. 2, 2019, *available at* https://www.sec.gov/comments/265-30/26530-4842061-177137.pdf.
[15] See Kevin McPartland, *Examining the Corporate Bond Block Trade Reporting Pilot*, June 4, 2019, *available at* https://www.greenwich.com/blog/examining-corporate-bond-block-trade-reporting-pilot.

(2) Remove the ability of other market participants to have essential price references;
(3) Potentially decrease posted public, available liquidity and widen spreads;
(4) Create an impediment to best execution and quality transaction cost analysis;
(5) Potentially increase volatility in times of market stress;
(6) Potentially lead to a consolidation of trading at the largest dealers; and
(7) Inadequately capture market quality metrics for evaluation.

Additionally, and perhaps most importantly, the FINRA Proposal is nearly completely devoid of evidentiary support for either the objective or the methods taken to achieve that objective.

Discriminatory Impact on Market Participants and Potential Misuse of Inside Information. As the FIMSAC Dissenter Letter noted, the proposal would simply favor the largest dealers, and perhaps a handful of the largest investors, over other market participants. For 48 hours, only the parties to the deal, and those whom they care to tell, would be aware of the trade. The dealer would know the price at which it had just transacted a large block, but others would not. Could it then use that material, non-public information to trade that security and potentially related or similar securities in the markets? Could it tip others to trade on that information? This is not only discriminatory, but raises significant questions about market integrity.

Loss of Price References for Market Participants. Most market participants would lose an incredibly valuable reference point--not just for the security traded, but for similarly situated securities. This could impact evaluative pricing tools, such as those offered by third parties, and relied upon by many market participants – not just in the pricing those specific bonds but other bonds where those prices are used in evaluating fair values. Put simply, all investors other than the dealer involved in the trade would not be aware of the important reference point. This could lead to executions for retail and other institutional investors at materially worse prices.

Further, this loss of a reference price may materially impact a number of other financial products, such as bond-based ETFs. As the FINRA Proposal notes:

> The impact of delayed reporting may well have an amplified effect on securities deriving their value from corporate bonds. The impact could lead to less efficient pricing of index-based products, such as ETFs, and derivatives, such as total return and credit default swaps. If the pilot makes it more difficult to mark-to-market the relevant securities, market participants, who do not trade blocks benefitting from delayed reporting dissemination, may be more likely to use stale prices for operational and accounting purposes.[16]

[16] FINRA Proposal, at 28.

We agree with this significant concern. The data reflects that as much as 50.5% of those block trades occur in bonds that are included in at least one of the seven largest fixed income ETFs. This is a significant concern for investors and market makers in those ETFs.

Decreased Posted Liquidity and Wider Spreads. Market makers and other market participants -- particularly those in the electronic markets -- would be unaware of significant trades for 48 hours. The impact here is not only when the block is the only "relevant" price on the day but also because the delay distorts the observed bond's daily high or low price. For example, according to an analysis by Bloomberg, 41.5% of block trade prices were outside the high/low of the day set by any observed non-block price.

This could leave market makers and investors subject to dramatically increased risk. Typically, market makers respond in such increased risk scenarios by decreasing the size of offerings available and widening the spreads. For example, suppose a large bank dealer engages in a large block trade that is not reported for 48 hours. It would know the price at which it had just transacted a large block, but others would not. Then suppose the dealer starts aggressively trading that security and similar securities in the electronic markets. It could, for example, sweep market makers quotes and make near-guaranteed profits at the expense of the uninformed market makers. To mitigate the risk of catastrophic losses, we would expect market makers in such scenarios to decrease the size of their posted liquidity and widen the spreads.

Impedes Best Execution and Transaction Cost Analysis. The delay would make it very difficult for firms to engage in meaningful transaction cost analysis thus hampering best execution obligations. This is particularly true in markets that are, like equities and derivatives markets, becoming increasingly time-sensitive, with real-time changes in prices coming over periods measured in fractions of a second, seconds, or minutes. In today's increasingly transparent fixed income market, a delay of two days is an eternity. The proposal also runs directly counter to the SEC's and FINRA's recent efforts to enhance best execution in fixed income securities trading.[17]

Increased Volatility and Decreased Liquidity in Times of Stress. A delay could exacerbate systemic risks and volatility. Again, without real-time transparency into large trades, market participants (including both investors and dealers) may withdraw from markets in perceived times of stress. In these cases when participants want more information, they would have less. Thus, the lack of references could lead to less-liquidity, not more. This risk is likely exacerbated as these markets become increasingly electronic. Electronic market makers would likely have to respond in times of stress by even further widening spreads or withdrawing from the market entirely, as fears of a large, unknown trade could materially change the values of swaths of underlying securities.

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[17] See, e.g., FINRA, *Best Execution: Guidance on Best Execution Obligations in Equity, Options and Fixed Income Markets*, Reg. Notice 15-46, Nov. 2015, *available at* https://www.finra.org/sites/default/files/notice_doc_file_ref/Notice_Regulatory_15-46.pdf.

Consolidation of Trading. If large trades are kept secret from the majority of market participants and regulators for up to 48 hours, investors and market participants will increasingly turn to those who are most likely to have more complete information. That will necessarily be just the handful of largest bond dealing banks. As a result, they will be able to make more informed markets and more profitable trades than other brokers or dealers--leading to further consolidation of bond market trading.

Inadequate "Market Quality Indicator" Metrics. Although FINRA notes that "as the FIMSAC recommended, and based on consultation with SEC staff, the pilot would be subject to early termination if market quality indicators demonstrate a significant disruption", there is very little discussion on "market quality indicators" and what constitutes a significant disruption. From our perspective, clear quantitative metrics need to be proposed, discussed and finalized. Developing clear goals, success metrics and "market quality indicator" metrics is important so we avoid a similar outcome as the U.S. equity market's tick size pilot. It is important to identify negative impacts that would inform the academics, participants and regulators to terminate the pilot early.

Lack of Evidentiary Support. Neither the FINRA Proposal nor the FIMSAC Recommendation upon which it is based appear to offer any data or evidence to support the identification of a "problem" with block trading in corporate bonds. In fact, the bulk of academic research in corporate bond trading supports increased transparency, not decreased. Further, as trade sizes have fallen, and electronification has increased, spreads have narrowed. Thus, the evidence about the current bond markets suggests that regulators should be further increasing transparency, as opposed to increasing opacity.

Interestingly, there is also almost no information regarding the specific choices made. For example, why is the delay 48 hours, as opposed to some other number of minutes, hours, days, or weeks? What are the perceived benefits and likely outcomes for the different delay period options? These and other preferences in the study should be examined and supported.

Conclusion

We support the objective of providing market participants with greater data and with easing potential inhibitions on trading of corporate bonds. That said, the FINRA Proposal does not do that. The FINRA Proposal could dramatically negatively impact market integrity for corporate bonds, and should be abandoned. We urge FINRA to consider going in the opposite direction, and further limit the exceptions to real-time reporting of corporate bond trades.

Thank you for your consideration. Should you have any questions or would like to discuss these matters further, please call me at (202) 909-6138.

Sincerely,

Tyler Gellasch
Executive Director

CC: Tom Gira, EVP Market Regulation and Transparency Services