August 21, 2018

Mr. Brent J. Fields
Federal Advisory Committee Management Officer and Secretary
Securities and Exchange Commission
100 F Street NE Washington, DC 20459

RE: Fixed Income Market Structure Advisory Committee, SEC File No. 265-30

Dear Mr. Fields:

The undersigned members of the Fixed Income Market Structure Advisory Committee respectfully submit the following comment on the "Preliminary Recommendation for a Pilot Program to Study the Market Implications of Changing the Reporting Regime for Block-Size Trades in Corporate Bonds" adopted, as amended, by the Fixed Income Market Structure Advisory Committee ("FIMSAC") in the public meeting on April 9, 2018 (the "Recommendation").

The FIMSAC Delayed TRACE Large Trade Reporting Recommendation

At its April 9, 2018 meeting, FIMSAC voted to advise the SEC to recommend that FINRA conduct a pilot study to better understand whether changing how FINRA disseminates reports of large corporate bond trades to the public would be beneficial. The current procedures provide for immediate dissemination by FINRA of trade reports (which required entities must make within 15 minutes of the trade) that include the price of the trade and a measure of the size of the trade. For trades in investment grade ("IG") bonds smaller than $5 million in par value, FINRA disseminates the full size of the trade. For larger trades, FINRA disseminates a note ("5MM+") that indicates that the trade size was $5 million or more. FINRA uses similar procedures for non-investment grade ("N-IG") bonds ("1MM+") except that the threshold is $1 million.

The FIMSAC majority recommends that FINRA not report IG trades larger than $10 million and N-IG trades larger than $5 million until 48 hours after the trade. All other trades would be reported immediately in full size. The Recommendation thus decreases price transparency for trades above these thresholds and increases size transparency for IG trades between $5 million and $10 million and N-IG trades between $1 million and $5 million.

The majority offered the following rationale for the change: The delayed reporting of large trades would give dealers more time to offset their positions so that they can offer more liquidity to large block sellers. Without this protection, dealers claim that their positions get front run. Although, in principle, the argument applies both to large purchases and large sales, in practice, the rule will primarily affect only large purchases as dealers rarely make large sales that they must subsequently cover.

We respectfully disagree with the Recommendation. This note identifies the economic implications of the proposed change and offers an alternative method for addressing the dealers' concerns.

Further, if a pilot study is undertaken, the study must include an adequate control sample to produce statistically meaningful results. As designed, unrelated changes in market conditions will inevitably ensure that multiple factors could account for the results. FINRA must design the pilot so that alternative explanations for the results can easily be ruled out. Only with a well-designed pilot can we ensure that the results will faithfully reflect market realities. That said, for the reasons offered below, we do not believe that a pilot study is necessary or wise.

Economic Implications of the Recommendation

Delayed reporting of large trade prices will certainly make it easier for dealers to distribute a large block because the investors to whom the dealers will distribute the block ("receiving investors") will have less information about the value of the bond. The dealers profit from this information advantage. To some extent, they may pass on the value of their information advantage to the block initiators (many of whom may be better informed than the dealer) in the form of better prices.

Stated more abstractly, information is power, and power produces profits. The proposed change will transfer power and thus wealth from receiving investors, who are typically smaller investors, to dealers and the large block initiating traders. The proposal thus will not promote interests of smaller traders, a value which several members of the Commission have stated that they hope to promote. We note that smaller investors are active participants in the corporate bond market. Between 2011 and 2017, 87% of all transactions reported on TRACE were retail- and small institutional-sized trades of less than $1 million. We do not believe that the market structure should favor large traders to the detriment of smaller traders.

To some extent, this transfer of power will allow large block-initiating traders to engage in more fundamental research that would lead to better pricing of bonds. Receiving investors thus would help pay for research by the large block initiators. But we note that this transfer is inefficient as dealers undoubtedly would capture some or even much of the benefit of knowing the block trade prices.

We also note that delayed reporting of large trades increases price uncertainty. Block trades larger than $10 million in IG bonds account for about a third of all reported IG TRACE trading volume, and those exceeding $5 million in N-IG bonds account for about 40% of reported TRACE N-IG trading volume. Delayed block price reporting exposes both buy and sell side participants to additional risk that they are transacting at terms inferior to those that they would accept with timely reporting of previously-completed block trades. Limited information on large transactions is particularly problematic during periods of market stress when the benefit of timely pricing information is large. At such times, price transparency helps ensure that market makers and authorized ETF participants engaged in deposit and redemption transactions continue to participate in the markets. Since their trades facilitate liquidity transfer, they tend to stabilize prices.

We do not give much credence to the claim that publishing trade size allows the dealers to be front run. We do not believe that many traders sell ahead of dealers who are distributing blocks with the expectation of later repurchasing their bonds at lower prices. To do so requires that they either already own the bond or that they borrow the bond. The owners generally are reluctant to sell because they like what the own (which is why they own it), and short selling can be expensive. Moreover, in comparison to equity markets, the price moves associated with fundamental information in the bond markets—especially for IG bonds—are small so that the profits associated with front running are not likely large.

We do recognize that the market impact of quickly selling large blocks of even IG bonds can be significant because sellers must find buyers. But we also know that sellers can reduce that impact by selling slowly. Dealers who acquire large blocks would like to be rid of them as quickly as possible. While giving them more time to sell them would reduce their potential impact on price, we note that they acquire this problem only because they take it from the large block initiators. We do not believe that the market structure should favor large traders to the detriment of smaller traders. Large traders can minimize the costs of selling their bond blocks by breaking them into smaller pieces and selling them in parts over time just as they do in the equity markets.

We do not believe that the proposed increase in size transparency for IG trades between $5 million and $10 million and N-IG trades between $1 million and $5 million has much meaningful value to traders or investors. Size information is important primarily because large size helps ratify the price report. The additional value of knowing the exact size of an IG trade of say $8.5 million over simply knowing that it is larger than $5 million is small. That value comes from two types of information: First, the additional information that the trade is $3.5 million larger than its minimum possible size given the $5 million threshold. We believe that the value of this information is not significant as the market will know that the trade is large either way FINRA reports it. The second type of additional information that we would learn from reporting the actual sizes of "$5MM+" trades that are smaller than $10 million is that these trades are not significantly larger than their full, masked sizes. As presently reported, some market participants might think that these trades are significantly larger than they are. Again, this information is not particularly valuable because the trade is large in any event. For those who believe that the latter type information is important (perhaps because it prevents traders from making decisions based on inflated expectations of trade sizes), we note that reporting full trade sizes would solve the problem.

We also are concerned that delayed dissemination of block trade reports can mislead the market about supply and demand conditions when dealers distribute the block in smaller trades whose reports are immediately disseminated. For example, if a dealer crosses $20 million in bonds from one seller to four buyers each buying $5 million on a riskless-principal basis, under the recommended proposal, FINRA would delay dissemination of the $20 million dealer buy report but would immediately disseminate reports each of the $5M dealer sales. The immediately disseminated reports would give the appearance of surplus buying demand and the possibility that one or more dealers have been left short facilitating this customer demand. The response to such reports could artificially push the price of the bonds higher, at least until FINRA disseminates the "$10MM+" dealer buy trade two days later. This issue is especially important to smaller dealers who typically do not participate in block trades. Delayed dissemination of trade reports will make it more difficult for smaller dealers to compete effectively with larger dealers who see a larger fraction of the order flow.

Finally, we are concerned that the proposed change would increase trade sizes. The delayed reporting of large trades would encourage traders to trade blocks with qualifying size rather than smaller blocks or blocks broken into smaller pieces. The Recommendation, if implemented, thus would decrease price (and size) transparency by more than the current trade size distribution would suggest, and it could distort normal incentives to trade slowly and more responsibly.

An Alternative Recommendation

If we assume, as the majority asserts, that dealers need additional protection from front-runners when distributing large blocks, we believe that a different change in how FINRA disseminates TRACE trades reports could accomplish this objective without disadvantaging receiving investors. FINRA could simply reduce the current size reporting thresholds from $5 million and $1 million (IG and N-IG, respectively) to lower values of say $2.5 million and $750,000. The decrease in reported sizes would protect the dealers by further hiding the full sizes of the blocks that they have purchased and must distribute. But the receiving investors would still know the actual trade prices. This proposal would decrease size transparency, but the harm to the market would be small while potentially providing some valuable protection to dealers.

As an offset for the decreased size transparency, the full sizes of all IG trades between $1 million and $10 million should be published two market days after they occur. Full sizes for those trades above $10 million should be published four market days after they occur. Likewise, for N-IG bonds, the full sizes of all trades between $750,000 and $2.5 million should be published two market days after they occur with all larger sizes published four market days later. (Presently FINRA publishes the full sizes of 5MM+ trades in IG bonds and of 1MM+ trades in N-IG bonds six months after the transaction in its Historic TRACE Data Product). This proposal would accelerate timely reporting of transaction sizes for the largest trades—useful for reducing information asymmetries among market participants—while providing large traders the protection from parasitic trading that motivated the Recommendation.

Conclusion

Trade price transparency is essential to well-functioning capital markets. Substantial empirical evidence has shown that public dissemination of TRACE trade reports has saved public investors about $1B/year. We believe that it would be unwise to threaten these cost savings.

Dealers in all markets have opposed timely reporting of block trade prices because it reduces their pricing power. In contrast, timely reporting of block trades helps buy-side traders better understand market conditions so that they can arrange trades on more favorable terms.

We note that although large equity blocks represent substantially more credit risk than do similarly sized bond blocks, the US equity markets do not exempt large blocks from printing requirements. While we recognize important differences in how that bonds and equities derive their values from corporate cash flows, these differences do not bear on the question of when FINRA should report trade prices to the public.

Many alternative reasons explain why large dealers are unwilling to commit as much capital as they previously committed to the capital markets. The primary explanations include (a) the growth of electronic trading and with it increasing competition from non-traditional proprietary traders who now provide substantial competition to traditional dealers, and (b) post-crisis reforms in bank regulation, including the Volcker Rule and Basel III requirements, that have affected willingness or ability to commit capital by bank-affiliated dealers. Many of traders at these dealers have left banks to start or join proprietary trading firms subject to less prudential banking regulation. Secondary reasons include the decrease in bond volatility due to low interest rates and substantial economic growth. These processes are decreasing the costs of bond liquidity to traders. The fact that traditional bank-affiliated dealers may participate in the markets less than they once did should not concern regulators. The modernization of other markets led to similar results with substantial improvements in liquidity. Regulatory attention should focus on reducing institutional frictions that impede broad investor participation in liquidity provision.

We cannot see how issuers benefit from the Recommendation. Secondary markets facilitate capital formation because issuers can sell their issues in the primary market at higher prices if investors know that they can resell their bonds in liquid secondary markets. Transferring power from receiving investors to dealers and larger investors cannot lead to a net increase in secondary market liquidity, if only because the additional profits that dealers make come at the cost of investors. Accordingly, we believe that the Recommendation is unwise.

Finally, we note that pilot studies are expensive. We do not believe that every possible issue deserves a pilot study, and especially those for which the underlying issues are well understood. Thus, although the Recommendation merely calls for a pilot study, we believe that undertaking it would be unwise as its potential costs are much greater than the expected benefits.

If, despite our reservations, a pilot study ultimately is undertaken, that study must be well designed. It must have an adequate control sample to ensure that the results are not due to spurious issues.

For the many reasons stated above, we do not see how a reallocation of power to dealers and indirectly to their large block-initiating clients from receiving investors is of any significant advantage to the economy and the capital formation process. Accordingly, the following members of FIMSAC dissent from the Recommendation.

Sincerely,

Larry Harris
Fred. V. Keenan Chair in Finance
USC Marshall School of Business

Kumar Venkataraman
James M. Collins Chair in Finance
Southern Methodist University

Elisse Walter
Former Chairman
U.S. Securities & Exchange Commission