

Executive Summary

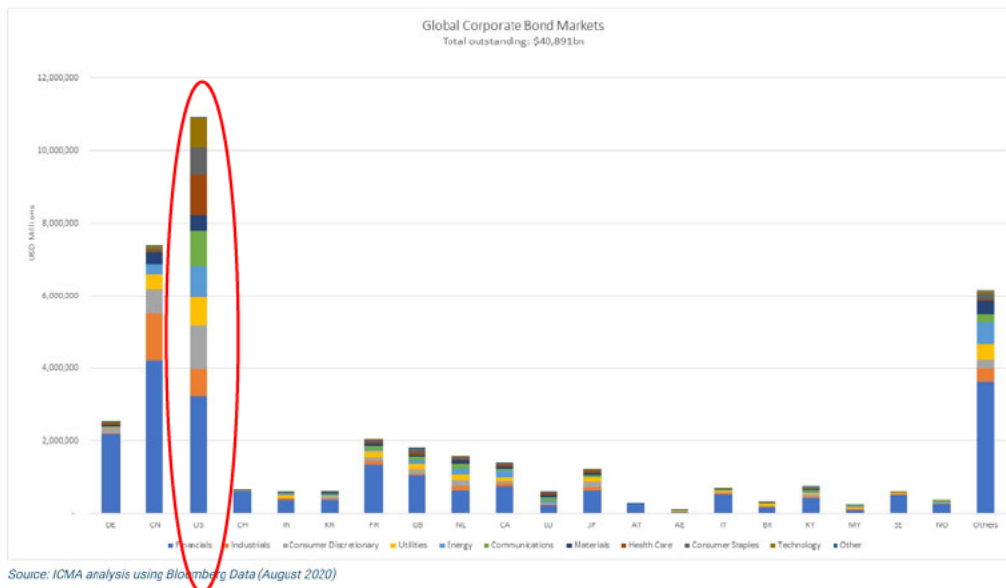
The Security and Exchange Commission’s request for feedback on rule 17a-7 is timely and relevant given the growth in the outstanding size of fixed income assets over the last 20 years. In certain fixed income markets, investment companies have become the dominant holders of fixed income securities. Rule 17a-7 is intended to provide a framework for cross trading which eliminates trading inefficiencies and lowers administrative costs which ultimately benefit end investors¹. However, most fixed income markets lack infrastructure to produce “readily available quotes” which are an essential protective condition outlined in 17a-7. For the corporate bond market, recent developments in transparency now make it possible for 17a-7 to be utilized based on [previous SEC guidance for cross-trading in markets that lack “readily available market quotations.”](#) By following established SEC guidance for utilizing consolidated transaction data and recently developed consolidated corporate bond quote information, investment companies that hold corporate bonds can increase cross-trading activity which benefits their clients and reduces a potential risk to overall market stability.

BondCliQ

[BondCliQ](#) is a DaaS platform specifically designed to improve price transparency in the US corporate bond market by establishing the industry’s first consolidated quote platform (think NASDAQ for bonds). Currently, BondCliQ gathers direct institutional price contributions from 45 participating dealer which generate over 45,000 quotes a day. Funds use BondCliQ data to discover tradeable institutional prices and BondCliQ data is directly distributed into three leading buy-side order management systems (Charles River, Tora, ThinkFolio). Our team has over 100 years of combined service in the corporate bond market with experience at electronic trading platforms, sell-side institutions, inter-dealer brokers, and buy-side institutions. **BondCliQ’s comments on 17a-7 will be exclusively from the perspective of the corporate bond market.**

Growth in US Corporate Bond Market

Since 2008, central banks (BOJ, ECB, BOE, and US Fed) have collectively suppressed interest rates and employed bond buying as a [tactic to protect and stimulate their respective regional economies](#). This activity has artificially accelerated the growth in the outstanding size of global corporate debt. Currently, the US corporate bond market is the largest in the world:

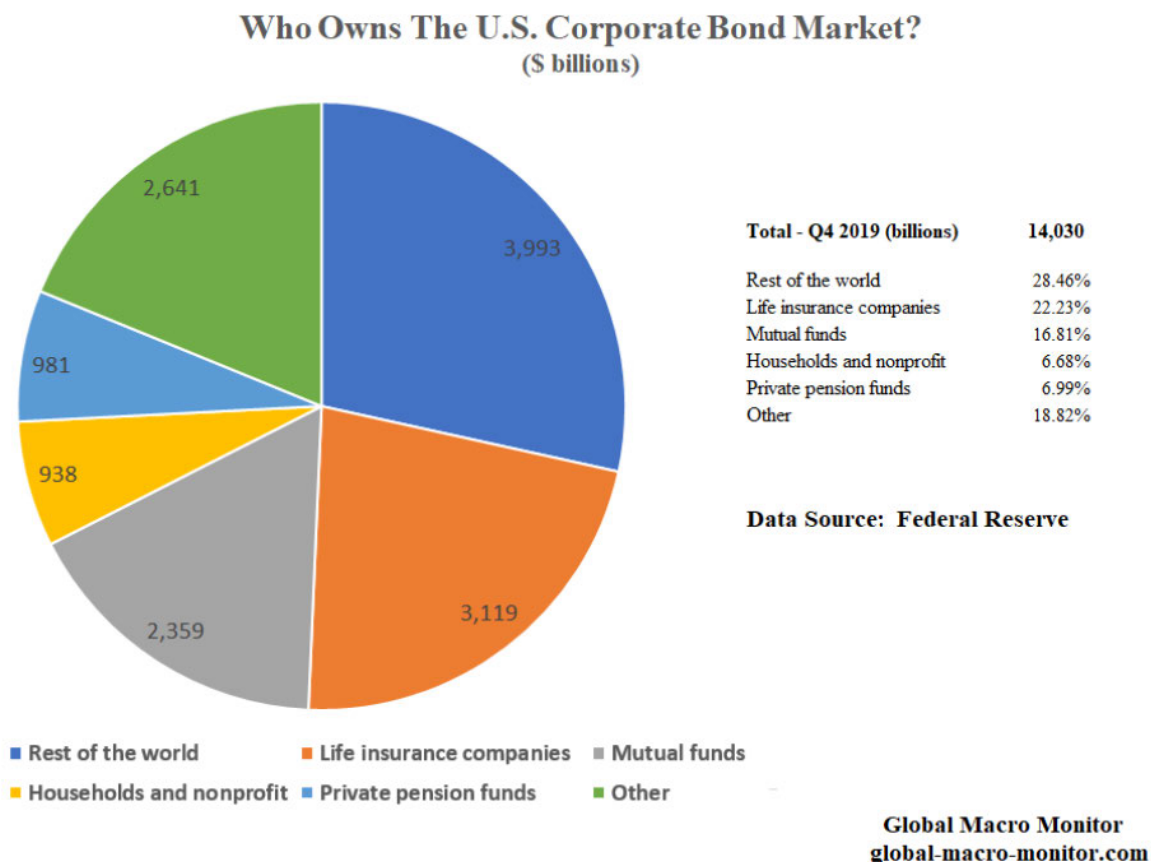


¹ Statement on Cross Trading - Securities Industry Association (SIA now SIFMA) May 19th, 1998 - <https://www.sifma.org/wp-content/uploads/2017/05/sia-submits-comments-to-the-us-department-of-labor-on-cross-trades-of-securities.pdf>

[Corporate bond issuance by US companies continues to boom](#). In terms of a moving 12-month sum, the issuance of investment-grade bonds by US companies advanced 70% year-over-year to a record high \$1.508 trillion for the year-ended August 2020.²

Corporate Bond Market Holders

According to the most recent data from the Fed, US insurers, funds, and private pension funds hold over 46% of outstanding corporate bonds, totaling \$6.4 trillion in notional size. Their aggregated holdings are larger than the entire size of the 2008 corporate bond market:



The combination of market size and massive holdings by US asset-managers establish US corporate bonds as a priority security when examining whether the protective conditions of 17a-7 can be reasonably met.

Readily Available Market Quotations

Financial securities do not exist under a uniform market structure and have material differences in a critical area related to 17a-7 compliance: the existence of readily available market quotations. As referenced in the [March 11th, 2021 SEC Staff Statement on Investment Company Cross Trades](#), establishing an independent, objective price is an essential condition outlined under 17a-7:

Rule 17a-7 generally requires that cross trades (a) involve a security for which market quotations are readily available; and (b) be affected at the independent current market price of the security

² Corporate Bond Issuance Boom May Steady Credit Quality, On Balance – Moody’s Analytics (<https://www.moodyanalytics.com/-/media/article/2020/weekly-market-outlook-corporate-bond-issuance-boom-may-steady-credit-quality-on-balance.pdf>)

Meeting this requirement is dependent on the use of “readily available market quotations.” In December 2020, the [SEC adopted Rule 2a-5 \(Valuation Rule\) to define what it means for market quotations to be readily available](#). The Valuation Rule provides that “a market quotation is readily available only when that quotation is a quoted price in active markets for identical investments that the fund can access at the measurement date, provided that a quotation will not be readily available if it is not reliable.”³ Most fixed income markets do not contain market pricing information that consistently fits the “readily available market quotation” definition.

Current State of Corporate Bond Pricing

Historically, pricing information in the corporate bond market has not been derived from a single source and has been fragmented across multiple electronic trading platforms, communication systems, and market analytics providers. As a result, buy-side market participants developed differing methodologies for obtaining and utilizing quote information for key functions like portfolio valuations, proving best-execution, and calculating transaction costs. The use of divergent pricing data sources has generated outcomes that directly contradict observable market conditions. This issue was clearly articulated by the [recent discrepancies between corporate bond ETF market pricing and the end-of-day net asset value \(NAV\) calculations of those indices](#). The pricing to valuation problem was so persistent, that the SEC gathered leaders from the asset management community (AMAC) in May of 2020 to work on a resolution:

Some ETPs (most notably fixed income ETFs) experienced notable divergences between their market prices and net asset values (NAVs) At one point amid the COVID-19 volatility, more than 700 ETFs, accounting for roughly a third of all ETF assets, traded at a discount to their NAV of at least 1 percent

[SEC Asset Management Advisory Committee Report – Recommendations Regarding COVID-19 Volatility](#) (September, 16th, 2020)

AMAC focused on four potential changes to fixed income market structure that they believed would address the discrepancy issues by enhancing transparency and price discovery in fixed income markets:

- *Aggregating bids and offers through FINRA’s Trade Reporting and Compliance Engine (TRACE)*
- *Evolving market standards to encourage more use of firms quotes;*
- *Disseminating a national best bid and offer; and*
- *Imposing tighter reporting and public dissemination requirements for bonds*

The suggested AMAC changes are designed to centralize market pricing data to resolve the NAV complications for corporate bond ETFs. We believe that a consolidated quote platform for corporate bonds would centralize pricing and create the structural architecture needed to allow advisors and funds to utilize 17a-7 for corporate bond cross-trading. This view is based directly on a 17a-7 methodology for creating an independent price that was previously suggested by the SEC.

Consolidated Quote Systems

Consolidated quote systems are NOT trading platforms and are best described as public “bulletin boards” that collect and display bids and offers. The consolidated quote approach to organizing market data creates a single, objective reference point (fair pricing) for a given security. NASDAQ (National Association Securities Dealers Automated Quotation) was launched as the first consolidated quote system for US equities in 1971. Prior to NASDAQ, pricing information in the US equity market was just like the current corporate bond

³ SEC Issues Statement on Investment Company Cross Trading Practices Potentially Impacted by the Valuation Rule (March 15th, 2021 – The 40 Act Blog - <https://40actblog.sewkis.com/sec-issues-statement-on-investment-company-cross-trading-practices-potentially-impacted-by-the-valuation-rule/>)

market, fragmented across multiple venues and communication systems. The influence of NASDAQ on securities market development is undeniable as other markets have mimicked the original NASDAQ system over the past 50 years:

Market	Year	Consolidated Quote Platform
Listed US Equities	1975	Consolidated Quote System (CQS)
Foreign Exchange	1981	Reuters Monitor Dealing Service (RMDS)
European Equities	1986	Stock Exchange Automated Quotations (SEAQ)
US Government Bonds	1991	GOVPX

When faced with a request for no action for 17a-7 for municipal bonds, the SEC used NASDAQ official closing price data to suggest an alternative methodology for cross-trading securities that lack readily available market quotations.

Municipal Bond Market 17a-7 No Action Example

In 2006, the United Municipal Bond Fund requested an extension of 1995 no-action for 17a-7 to cover the use of a different independent pricing service for cross trading municipal bonds. The fund's initial no action request was because **municipal bond markets do not have "readily available market quotations."** The SEC Office of Chief Counsel Division of Investment Management used their [public response](#) as an opportunity to provide guidance on how different pricing data could be applied to 17a-7 for markets that don't have "readily available market quotes." The SEC specifically used consolidated quotes from NASDAQ as an example for generating eligible pricing information. Here are some key principles articulated by the SEC Chief Counsel Division relating to price contributions for internal crossing:

- *We did not intend that FTID would be the only independent pricing service that could be used by funds relying on the letter*
- *It may be appropriate for a fund, subject to the approval of its board of directors, to use other independent pricing services*
- *We would not recommend enforcement action to the Commission under section 17(a) of the 1940 Act against the Municipal Funds if they use SPSE (or any other independent pricing service) as their independent pricing service and engage in 17a-7 transactions involving municipal securities for which market quotations are not readily available,*

Those principles clearly indicate that the use of independent pricing services for internal crossing of municipal bonds would not result in action by the SEC. However, the Chief Counsel also included key guidance on the use of consolidated quote data as well:

We also wish to take this opportunity to note that, in our view, the use of another pricing methodology, the Nasdaq Official Closing Price ("NOCP"), is consistent with the policies of section 17(a) and rule 17a-7. Rule 17a-7(b)(1) provides that the current market price for an "NMS stock," as that term is defined in 17 CFR 242.600, is

[T]he last sale price with respect to such security reported in the consolidated transaction reporting system ('consolidated system') or the average of the highest current independent bid and lowest current independent offer for such security (reported pursuant to 17 CFR 242.602) if there are no reported transactions in the consolidated system that day

We believe that funds' use of NOCP prices in 17a-7 transactions would be consistent with the policies underlying section 17(a) and rule 17a-7 because of the manner in which the NOCP prices are independently determined. We believe that NOCP prices provide "an independent basis for determining that the terms of the transaction are fair and reasonable to each participating investment company

and do not involve overreaching." We would not recommend enforcement action to the Commission under section 17(a) of the 1940 Act against affiliated funds if, when engaging in 17a-7 transactions, the funds determine the current market price of a security that is NMS stock by using the NOCP price rather than by using one of the methodologies listed in rule 17a-7(b)(1) 9 Of course, the funds must also comply with the other requirements of rule 17a-7 Please note that this position represents our view on enforcement action only and does not express any legal conclusions on the issues presented

We view the voluntary addition of guidance from the SEC Chief Counsel Division as a blueprint for how all fixed income markets that lack readily available market quotations could source eligible data for cross-trading. Through recent developments, the corporate bond market now has the structural components required to utilize the SEC Chief Counsel's alternative cross-trade pricing methodology.

TRACE + Consolidated Quotes = Official Closing Prices for Corporate Bonds

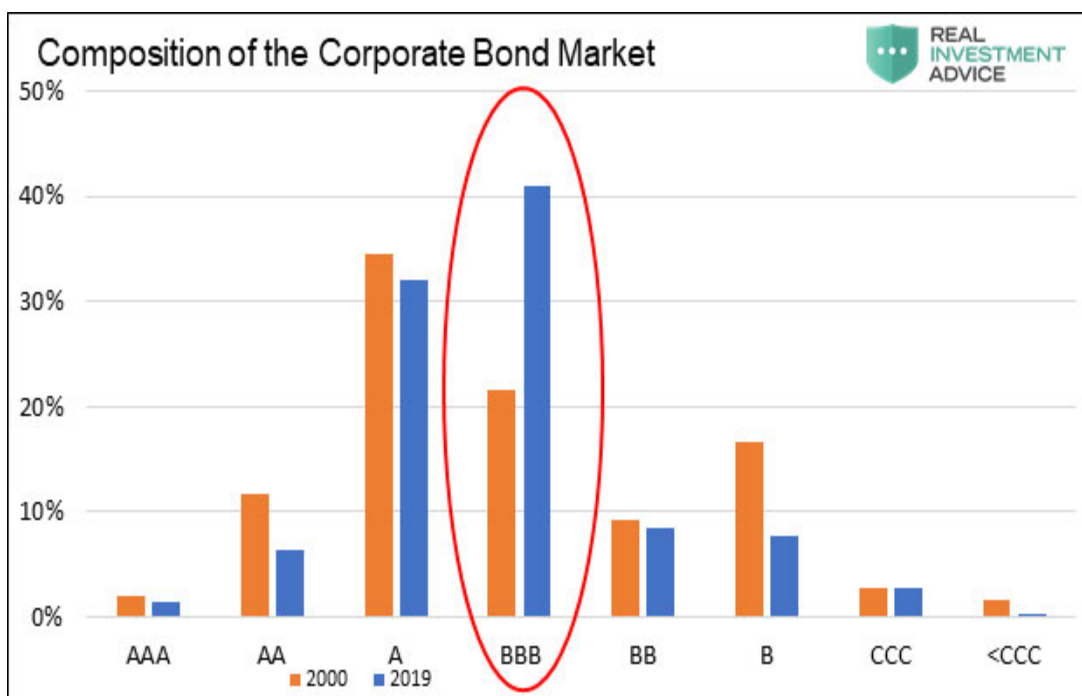
In 2002, FINRA (formerly known as NASD) launched the Trade Reporting and Compliance Engine (TRACE) for corporate bonds. Today, all US corporate bond transactions are reported to FINRA and distributed via TRACE which is identical to the NASDAQ consolidated transaction reporting system that the SEC Chief Counsel Division referenced. BondCliQ has created the corporate bond market's first consolidated quote system. Leveraging closing prices generated by consolidated transactions and consolidated quotes is the exact methodology suggested by the SEC to establish the independent pricing for cross trading when a market lacks readily available market quotes. By following this path, **the integrity of cross trading can be maintained consistently in a material number of corporate bonds.**

Request for Engagement

The SEC Staff Statement on Investment Company Cross Trading requested feedback on a large list of questions. Commentary on these questions is dependent on the perspective of a given market. BondCliQ is providing commentary on selected questions raised by the SEC Staff Statement from the perspective of the US corporate bond market, an area where we feel we are qualified experts:

What types of securities would advisers like to cross trade but believe they cannot do so under the current rule 17a-7?

BondCliQ Response: [Over the past 20 years, the percentage of the corporate bond market comprised of BBB-rated debt has increased:](#)



Previously, BBB-rated securities were not easily crossed under the interpretations of 17a-7 which increases risk to overall market stability. Any BBB rated bond that is downgraded must be purged from the holdings of all investment grade bond funds and could likely cause material disruption to trading in both investment grade and high-yield markets:

“Investor concerns over global IG downgrades to HY status have escalated significantly. This fear is not without justification,” UBS strategist Stephen Caprio said in a note. “The threat of IG downgrades could induce forced selling and lead to higher financing costs for large indebted companies, while increased HY supply could widen spreads.”

[‘Fallen Angels’ are posing the biggest threat to the bond market this year](#) – CNBC (January 22nd, 2019)

Utilizing closing prices comprised of TRACE transactions and consolidated quotes for cross-trading would reduce the potential negative impact of “fallen angels” by allowing asset-managers who have investment-grade and high-yield funds to transfer assets without flooding the market with supply.

To what extent do funds’ current cross trades not have readily available market quotations as defined in the Valuation Rule?

BondCliQ Response: The 2a-5 Valuation Rule definition for “readily available market quotation” sets requirements for pricing data that is not currently attainable in the US corporate bond market. Therefore, cross trades for corporate bonds must be routinely covered by no action/no enforcement exemptions. Rather than change the standard or alter the definition, the corporate bond market can use the [SEC Chief Counsel Division guidance on applying the NOCP data by leveraging TRACE and pricing information from a consolidated quote platform](#).

What are the advantages and disadvantages of the threshold requirement rule in 17a-7 that a security have a “readily available market quotation”?

BondCliQ Response: The current “readily available market quotation” threshold may result in an uneven playing field for corporate bond asset managers. Large funds have the dealer relationships (access to pricing), technology systems and legal & compliance resources to utilize cross-trading on a broader scale than smaller corporate bond funds. [The SEC Chief Counsel Division guidance on applying the NOCP data](#) helps rectify this issue by providing all funds, large and small, with the same process for leveraging a market-wide alternative to readily available market quotation data.

What other criteria for the transactions would protect against conflicts of interest or other risks of cross trades?

BondCliQ Response: Within the 2a-5 Valuation Rule definition for a “readily available market quotation” is a provision that the quote will not be deemed readily available if it is not reliable. Quote reliability is a subjective measurement that needs further definition to protect clients from inaccurate cross-trade markets, manipulation, or other conflicts of interest. Dealer quote consolidators like BondCliQ have spent considerable time with our customers to understand the problem of quote reliability and have explored ideas for improving the integrity of displayed market prices for trading. Here are two approaches based on those client discussions:

- An objective threshold for quote reliability could be directly determined based on market depth. For example, at least three or more dealers must provide quotes in a bond over the trading day for the resulting cross trade price to be deemed reliable.
 - With this provision in place, the aggregate number of dealer quotes would serve as a quality assurance protection when assessing the reliability of the cross-trade price.
- Dealer rankings can be applied to quoted prices by comparing the consistency, accuracy, and competitiveness of an individual dealer’s quote to all other dealers quoting that bond. Rankings would illustrate the reliability based on the historical behavior of the price provider which would help determine which contributions should be used for cross-trade pricing.

Conclusion

In the corporate bond market, investment companies, and the end-investors they represent, stand to gain from sensible modernization of Rule 17a-7. This process can be informed by [previous SEC no enforcement guidance on how fixed income markets that lack “readily available market quotations”](#) can use an alternative methodology for sourcing independent pricing information. By allowing data from pricing services as well including NASDAQ-like official closing prices, funds can establish the necessary protective conditions for cross trading a broader universe of corporate bonds. It is important to note that **the current US corporate bond market has the structural components to mimic the NASDAQ Official Closing Price process through TRACE and price data from a consolidated quote platform (BondCliQ).** The use of NASDAQ-like official closing prices for US corporate bond cross trading not only improves performance for end-investors but does so using a process that can be easily leveraged by all asset-managers, large and small.

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