

June 11, 2019

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

**Re: Proposed Pilot Program on Block Trade Dissemination of Corporate Bonds**

Dear Ms. Asquith:

We appreciate the opportunity to provide comments to FINRA on the proposed pilot program relating to block trade dissemination of corporate bonds (the “Proposed Pilot”).<sup>1</sup> Based on recommendations from the Securities and Exchange Commission’s Fixed Income Market Structure Advisory Committee (“FIMSAC”), the Proposed Pilot makes two changes to the current post-trade transparency framework: (1) block thresholds are raised from \$5 million to \$10 million for IG bonds and from \$1 million to \$5 million for non-IG bonds, and (2) a 48-hour dissemination delay is implemented for trades above the block thresholds.

Considered together, these changes dramatically reduce market transparency for investors. Even with the higher block thresholds, FINRA estimates that 56% of volume in IG bonds and 85% of volume in non-IG bonds may be subject to a 48-hour dissemination delay during the Proposed Pilot.<sup>2</sup> This means that, for a significant percentage of the overall market, no price transparency will be provided to investors for 48 hours, in stark contrast to the real-time post-trade transparency currently available.<sup>3</sup>

Certain FIMSAC members attempted to rationalize this reduction in transparency by asserting that liquidity conditions for block trades would improve as a result.<sup>4</sup> However, both FIMSAC and FINRA have been unable to demonstrate that (a) block trade liquidity has significantly deteriorated in recent years, and (b) any such deterioration is directly attributable to the current post-trade transparency framework. As a result, there is little evidence to suggest that the Proposed Pilot will meaningfully improve liquidity conditions. Instead, the costs and complexity of the Proposed Pilot significantly outweigh the asserted benefits, as it will negatively impact a wide range of market participants, including retail and institutional investors, smaller liquidity providers, new electronic trading platforms, and investors in correlated products, such as ETFs. We urge FINRA to instead focus on market structure initiatives that are designed to increase liquidity by making the corporate bond markets more fair, open, competitive, and transparent.

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<sup>1</sup> FINRA Regulatory Notice 19-12 (April 12, 2019), available at: <http://www.finra.org/industry/notices/19-12>.

<sup>2</sup> *Id.* at page 26.

<sup>3</sup> At the moment, all secondary market transactions in TRACE-eligible corporate bonds must be reported to FINRA as soon as practicable, but no later than 15 minutes after the time of execution.

<sup>4</sup> See Transcript of FIMSAC Meeting (January 11, 2018), available at: <http://www.sec.gov/spotlight/fixed-income-advisory-committee/fimsa-011118-transcript.txt>.

## I. The Proposed Pilot Fails to Satisfy a Cost-Benefit Analysis

### A. The Asserted Benefits of the Proposed Pilot Are Illusory

Proponents of the Proposed Pilot claim that reducing post-trade transparency will improve liquidity conditions for block trades.<sup>5</sup> However, this claim is undermined by a failure to demonstrate that (a) block trade liquidity has significantly deteriorated in recent years, and (b) any such deterioration is directly attributable to the current post-trade transparency framework.

First, academic research has failed to substantiate claims that corporate bond liquidity has deteriorated in the period following the financial crisis. Instead, research has generally found that corporate bond liquidity remains robust.<sup>6</sup> Available data can support reaching this conclusion even for block trades, as price-based measures appear to have improved for block trades compared to immediately following the financial crisis.<sup>7</sup> Similarly, data suggests that block trades continue to account for a consistent percentage of overall market trading activity. For example, IG trades above the new \$10 million block threshold accounted for 33.8% market share in 2018, compared to 32.1% in 2013, while non-IG trades above the new \$5 million block threshold appeared to maintain a relatively constant market share between 2013-2018.<sup>8</sup>

Second, to the extent there has been any deterioration in block trade liquidity, there is no evidence to suggest that it is due to the current post-trade transparency framework. In contrast, academic research has found that post-trade transparency has improved corporate bond liquidity and has reduced transaction costs.<sup>9</sup> Post-trade transparency has benefited not only retail investors,

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<sup>5</sup> See *id.*

<sup>6</sup> See, e.g., Adrian, T. et al., “Has U.S. Corporate Bond Market Liquidity Deteriorated?” Liberty Street Economics - Federal Reserve Bank of New York (Oct. 5, 2015), available at: <http://libertystreeteconomics.newyorkfed.org/2015/10/has-us-corporate-bond-market-liquidity-deteriorated.html>; Bessembinder, H. et al., “Capital Commitment and Illiquidity in Corporate Bonds” (Aug. 28, 2017), available at: <http://ssrn.com/abstract=2752610>; “Examination of Liquidity of the Secondary Corporate Bond Markets” IOSCO (February 2017), available at: <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD558.pdf>; and Trebbi, F. & Xiao, K., “Regulation and Market Liquidity” (May 2016), available at: <http://faculty.arts.ubc.ca/trebbi/research/tx.pdf>.

<sup>7</sup> See Anderson, M. et al., “Is post-crisis bond liquidity lower?” (April 21, 2017), available at: [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2943020](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2943020). See also “Rise of ETFs Is Improving the Bond Market, Say BofA, Jane Street,” Bloomberg (June 5, 2019), available at: <https://www.bloomberg.com/news/articles/2019-06-05/bofa-jane-street-say-rise-of-etfs-is-improving-the-bond-market> (“The growth of fixed-income ETFs is making it easier to determine bond prices and smoother to carry out large trades, said Sonali Theisen, head of fixed-income market structure at Bank of America”).

<sup>8</sup> FINRA Regulatory Notice 19-12 at pages 24-25.

<sup>9</sup> See, e.g., Bessembinder, H., et al., “Market transparency, liquidity externalities, and institutional trading costs in corporate bonds” (2006) *Journal of Financial Economics*, available at: [https://www.researchgate.net/publication/222515781\\_Market\\_Transparency\\_Liquidity\\_Externalities\\_and\\_Institutional\\_Trading\\_Costs\\_in\\_Corporate\\_Bonds](https://www.researchgate.net/publication/222515781_Market_Transparency_Liquidity_Externalities_and_Institutional_Trading_Costs_in_Corporate_Bonds); Edwards, A. K., et al., “Corporate bond market transaction costs and transparency” (2007) *The Journal of Finance*, available at: [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=593823](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=593823); and Goldstein, M. A., et al., “Transparency and liquidity: A controlled experiment on corporate bonds” (2007) *Review of Financial Studies*, available at: [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=686324](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=686324).

but also institutional investors transacting in larger size.<sup>10</sup> In particular, academic research has found that post-trade transparency has caused “trading costs to decline significantly for the entire bond market”<sup>11</sup> and has even improved liquidity conditions for block trades, directly contradicting the claims made by those supporting the Proposed Pilot. Specifically, an analysis of the institutional 144A corporate bond market found that the introduction of post-trade transparency in 2014 significantly reduced transaction costs for block trades, with the largest reductions observed for blocks that exceed \$25 million in size.<sup>12</sup> In addition, there was no evidence that post-trade transparency reduced block trading volume or otherwise impeded the ability of market participants to execute blocks, or reduced dealers’ willingness to hold inventory.<sup>13</sup> In fact, overall trading volume of large blocks increased following the introduction of post-trade transparency.<sup>14</sup>

FIMSAC did not appear to consider the academic research above as part of its deliberations.<sup>15</sup> Moreover, FIMSAC did not explain why it narrowly focused on suggesting changes to the post-trade transparency framework, as opposed to considering other aspects of market structure that can impact liquidity conditions, such as regulatory capital requirements,<sup>16</sup> the ongoing transition to electronic trading, the observed increase in agency/riskless principal trading,<sup>17</sup> and liquidity dynamics in hedging instruments, such as single-name credit default swaps. Ultimately, neither FIMSAC nor FINRA were able to identify any academic research supporting the suggestion that reducing post-trade transparency can be expected to improve liquidity conditions for block trades. As a result, the asserted benefits of the Proposed Pilot appear to be unsubstantiated and illusory.

### *B. The Proposed Pilot Imposes Significant Costs on Market Participants*

The Proposed Pilot will significantly reduce market transparency for investors, with FINRA estimating that 56% of volume in IG bonds and 85% of volume in non-IG bonds may be subject to a 48-hour dissemination delay during the pilot.<sup>18</sup> The incremental size transparency provided

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<sup>10</sup> See, e.g., Asquith, P., et al., “The Effects of Mandatory Transparency in Financial Market Design: Evidence from the Corporate Bond Market” (April 2019), available at: <https://www.nber.org/papers/w19417>; and Goldstein, M. A., et al., “Transparency and liquidity: A controlled experiment on corporate bonds” (2007) Review of Financial Studies, available at: [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=686324](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=686324).

<sup>11</sup> Asquith, P., et al., “The Effects of Mandatory Transparency in Financial Market Design: Evidence from the Corporate Bond Market” (April 2019) at page 29, available at: <https://www.nber.org/papers/w19417>.

<sup>12</sup> Jacobsen, S., et al., “Does trade reporting improve market quality in an institutional market? Evidence from 144A corporate bonds” (2018) at pages 1 and 7, available at: [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3171056](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3171056).

<sup>13</sup> *Id.* at pages 7 and 21.

<sup>14</sup> *Id.*

<sup>15</sup> See Transcript of FIMSAC Meeting (January 11, 2018), available at: <http://www.sec.gov/spotlight/fixed-income-advisory-committee/fimsa-011118-transcript.txt>.

<sup>16</sup> For example, the leverage ratio is an important constraint on market makers in fixed income securities. See Saar, G., Sun, J., Yang, R., and Zhu, H., “From Market Making to Matchmaking: Does Bank Regulation Harm Market Liquidity?” (2019) at page 5, available at: [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3399063](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3399063).

<sup>17</sup> See Schultz, P., “Inventory Management by Corporate Bond Dealers” (2017), available at: [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2966919](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2966919).

<sup>18</sup> FINRA Regulatory Notice 19-12 at page 26.

by raising the block thresholds (i.e. from \$5 million to \$10 million for IG bonds and from \$1 million to \$5 million for non-IG bonds) fails to compensate for the fact that no price transparency will be provided to investors for 48 hours for block trades. This lack of price transparency for a significant portion of the corporate bond market will impose material costs on market participants, including:

- **Increased transaction costs.** Academic research has found that post-trade transparency reduces transaction costs, transferring wealth from dealers to customers, as customer bargaining power increases and liquidity providers can be held more accountable.<sup>19</sup> Reducing transparency can be expected to increase dealer rent taking, particularly for block trades that are eligible for the 48 hour dissemination delay.
- **New information asymmetries.** Counterparties to block trades will have more information than the rest of the market regarding the fair value of a particular bond. This can serve as an advantage when negotiating additional transactions in that bond during the 48 hour period, and can frustrate attempts by other market participants to accurately value a bond at any particular time, negatively impacting best execution assessments and mutual fund valuations.
- **Undermining FINRA guidance on fair pricing.** FINRA’s debt mark-up guidance requires, in the absence of relying on a dealer’s contemporaneous cost, that the dealer consider contemporaneous third-party inter-dealer and institutional transactions to determine the prevailing market price.<sup>20</sup> Under the Proposed Pilot, much of this valuable reference pricing information may be eliminated, in which case an important portion of FINRA’s debt mark-up “waterfall” guidance would be undermined, to the detriment of customer fair pricing.
- **Decreased competition.** Academic research has found that post-trade transparency has increased competition in the corporate bond market, with smaller dealers gaining market share.<sup>21</sup> In addition, market transparency is necessary in order to enable additional liquidity providers to enter the market. In contrast, the Proposed Pilot will primarily benefit the largest dealers.

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<sup>19</sup> See, e.g., Asquith, P., et al., “The Effects of Mandatory Transparency in Financial Market Design: Evidence from the Corporate Bond Market” (April 2019) at page 29, available at: <https://www.nber.org/papers/w19417>; and Jacobsen, S., et al., “Does trade reporting improve market quality in an institutional market? Evidence from 144A corporate bonds” (2018) at pages 1 and 7, available at: [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3171056](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3171056).

<sup>20</sup> FINRA Rule 2121.02(b).

<sup>21</sup> See, e.g., Bessembinder, H., et al., “Market transparency, liquidity externalities, and institutional trading costs in corporate bonds” (2006) *Journal of Financial Economics*, available at: [https://www.researchgate.net/publication/222515781\\_Market\\_Transparency\\_Liquidity\\_Externalities\\_and\\_Institutional\\_Trading\\_Costs\\_in\\_Corporate\\_Bonds](https://www.researchgate.net/publication/222515781_Market_Transparency_Liquidity_Externalities_and_Institutional_Trading_Costs_in_Corporate_Bonds); and Jacobsen, S., et al., “Does trade reporting improve market quality in an institutional market? Evidence from 144A corporate bonds” (2018), available at: [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3171056](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3171056).

- **Reduced innovation.** Reducing post-trade transparency may disrupt the ongoing transition to electronic trading venues, including all-to-all platforms. Adoption rates have increased as dealers have transitioned to more agency/riskless principal trading. However, providing large dealers with a new structural advantage may reduce investments in agency/riskless principal trading, and related electronic trading venues.<sup>22</sup>
- **Liquidity disruption in correlated products.** Liquidity providers in fixed income ETFs, for example, will likely increase spreads to account for the fact that certain market participants will have informational advantages regarding the fair value of a bond at any given time. Any decrease in liquidity will negatively impact ETF investors, including retail, and liquidity conditions in the underlying corporate bonds.<sup>23</sup>

In addition to the costs above, FINRA should consider the practical implementation costs associated with the Proposed Pilot, including the need for all market participants to track the test group assignments of each corporate bond. Finally, FINRA should consider whether the Proposed Pilot creates opportunities for market misconduct and abuse, as the newly created information asymmetries could incentivize activity designed to manipulate market pricing (for example, by printing small trades at significantly different price levels than a recently executed block trade that is eligible for the 48 hour dissemination delay).

As detailed above, the costs associated with the Proposed Pilot significantly outweigh the asserted benefits, which are unsubstantiated and contradict published academic research. We urge FINRA not to reverse post-trade transparency, which has yielded material benefits for end investors, without well-substantiated evidence of a market-wide problem that has directly resulted from the implementation of TRACE. As stated by SEC Chairman Arthur Levitt at the time, post-trade transparency was implemented in the corporate bond market “for one simple reason: investors have a right to know the prices at which bonds are being bought and sold. Transparency will help investors make better decisions, and it will increase confidence in the fairness of the markets. Simply put, it's in everybody's interests.”<sup>24</sup> The Proposed Pilot would undermine this landmark achievement and should not proceed in its current form.

## II. Recommended Improvements to the Proposed Pilot

The Proposed Pilot fails to satisfy a cost-benefit analysis as detailed above. However, if FINRA still determines to proceed, we would make two recommendations.

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<sup>22</sup> See Saar, G., Sun, J., Yang, R., and Zhu, H., “From Market Making to Matchmaking: Does Bank Regulation Harm Market Liquidity?” (2019), available at: [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3399063](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3399063) (showing that dealer balance sheet costs impact investments in agency/riskless principal trading).

<sup>23</sup> See “Rise of ETFs Is Improving the Bond Market, Say BofA, Jane Street,” Bloomberg (June 5, 2019), available at: <https://www.bloomberg.com/news/articles/2019-06-05/bofa-jane-street-say-rise-of-etfs-is-improving-the-bond-market>.

<sup>24</sup> Speech by SEC Chairman: The Importance of Transparency In America's Debt Market (Sept. 9, 1998), available at: <https://www.sec.gov/news/speech/speecharchive/1998/spch218.htm>.

First, we agree with FINRA that there must be a control group and that each proposed change to the current post-trade transparency framework must be independently tested. Given the resulting complexity, we would suggest that FINRA evaluate the two FIMSAC recommendations separately, starting with the less controversial proposal to increase the block thresholds.<sup>25</sup> This would allow FINRA to implement the higher block thresholds and evaluate any impact before then testing a dissemination delay for block trades. Such a staggered approach would reduce implementation costs and complexity for market participants.

Second, there should be clear metrics for evaluating the success of any pilot. With respect to a pilot that tests dissemination delays, these metrics should include (i) investor transaction costs, (ii) market maker spreads, (iii) spreads on limit order book retail bond platforms, and (iv) spreads in correlated products, such as ETFs. In addition, FINRA should attempt to assess the impact on competition between large and small dealers, the percentage of trading activity that is executed on a principal basis vs. agency/riskless principal, and the accuracy of prices produced by third-party bond evaluation services, such as Bloomberg and ICE, which are relied upon by mutual funds and ETFs. These metrics will provide a more complete picture of the practical effects of reducing post-trade transparency in the corporate bond market.

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We appreciate the opportunity to provide comments on the Proposed Pilot. Please feel free to call the undersigned at (646) 403-8235 with any questions regarding these comments.

Respectfully,

/s/ Stephen John Berger  
Managing Director  
Global Head of Government & Regulatory Policy

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<sup>25</sup> We note that the higher block thresholds would result in approximately 32.6% of IG volume being capped and 40.8% of non-IG volume being capped. See <https://www.sec.gov/spotlight/fixed-income-advisory-committee/fimsac-block-trade-recommendation.pdf>. This compares favorably to how block trade thresholds are set in other asset classes, such as the CFTC's OTC derivatives framework, where 33% of volume is intended to be capped. See Procedures to Establish Appropriate Minimum Block Sizes for Large Notional Off-Facility Swaps and Block Trades; Final Rule, 78 Fed. Reg. 32866 (May 31, 2013) at 32891, available at: <http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2013-12133a.pdf>.