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30 August 2019

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

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

Dear Ms. Asquith:

CFA Institute[1] is writing to provide comments to FINRA on its Proposed Pilot Program to Study Recommended Changes to Corporate Bond Block Trade Dissemination (the Proposed Pilot). CFA Institute represents the views of those investment professionals who are its members before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and on issues that affect the efficiency, integrity and accountability of global financial markets.

Executive Summary

CFA Institute more frequently is supportive of pilot programs because of the information they may generate to improve the matters under review. In this case, however, we do not support the pilot or its proposed structure for the pilot because of the expected harm it would pose to investors, market integrity, and market efficiency. The problems we expect to develop from the Proposed Pilot significantly outweigh the benefits supporters presume would occur.

We recognize the importance of ensuring that asset managers and broker/dealers can engage in block trades of corporate bonds without triggering significant adverse consequences for either. In a 2011 report on transparency in European bond markets[2] (the 2011 European Bond Markets Report) we noted, "In the case of block trading of securities, immediate publication of the

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[1] CFA Institute is a global, not-for-profit professional association of nearly 171,400 investment analysts, advisers, portfolio managers, and other investment professionals in 165 countries, of whom more than 164,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 154 member societies in 77 countries and territories.

[2] CFA Institute, *An Examination of Transparency in European Bond Markets* (2011). https://www.cfainstitute.org/-/media/documents/article/position-paper/an-examination-of-transparency-in-european-bond-markets.ashx (CFA Institute *2011 European Bond Markets Report*).

relevant trade information may expose the dealer to an adverse market movement as other market participants try to exploit the dealer's change in position."

Nevertheless, the difficulties created for broker/dealers and market-makers do not warrant market changes that, even for a limited time, significantly shift trading risks to investors for the benefit of those intermediaries. Even on a temporary and test basis, we believe a 48-hour delay in block-trade reporting will seriously undermine the integrity of the market structure for corporate bonds and sew investor distrust as to the value and accuracy of market data.

An additional concern relates to how the reporting delays will affect fund products. Keeping key pricing data from mutual and exchange-traded funds will prevent accurate and timely net asset value ("NAV") calculations for investors, thus spreading the loss of market integrity and investor trust to a significant and growing segment of bond market investors.

Finally, whereas the potential benefits to certain market participants from delaying block bond trade reporting are both uncertain and unlikely, the complications the Proposed Pilot would create for most other market participants, especially investors in bond funds, are both likely and certain.

It is for these reasons that we emphatically urge FINRA not to introduce the Proposed Pilot.

If the Proposed Pilot were to forego the 48-hour delay from its proposed structure, however, we would be willing to accept the Pilot's cap changes and different deferrals for long-term reporting, we would be willing to support the proposal.

Discussion

1. ***In either a dissemination delay or a delay with increased cap associated with changes in aggregate trading activity? In particular, does a decrease in transparency:***
    1) increase trading activity;
    2) increase liquidity;
    3) decrease time between transactions; or
    4) decrease uncertainty/error in prices?

    We would not be surprised if institutional investors show greater interest in execution of large blocks because of the Proposed Pilot's dissemination delay. Whether their institutional trade counterparties reciprocate with equal interest in this market, on the other hand, is a question of primary importance. We have little doubt such counterparties will still need to buy and sell bonds during the duration of the Proposed Pilot to meet their needs and those of their investment clients. But we also expect these counterparties to respond to the reporting delays by changing how they execute trades in unknown ways. Such changes may include changes in trading strategies such as spreading trades over several days to try to mitigate the information asymmetry contained within any single two-day period. They also may alter their pricing strategies to address the potential for adverse information hidden within the embargoed trade reports. Finally, they may conclude that given the risk that they will adopt a buy-and-hold strategy more frequently to avoid trading against a hidden market.

    Ultimately, the trade reporting delay would have a negative effect on the integrity of market prices and the accuracy of market data. Forcing investors to transact on the basis of potentially and purposefully distorted market data will shroud every trade during the Proposed Pilot with suspicion and uncertainty about what may or may not have occurred in the past two days and whether current/pending/latent trade decisions will run with or counter to the hidden market. Adjusting prices to mitigate these risks would increase capital costs for corporate issuers, ultimately undermining economic growth.

Academic research from the period surrounding the introduction of the Trade Reporting and Compliance Engine (TRACE) in 2002 provided strong evidence of the positive effects of transparency in the market for corporate bonds. Two such studies, in particular, considered how transparency affected investors' willingness to trade. Bessembinder and Maxwell[3] estimated that trading expanded for all bonds by 29 percent after TRACE was introduced, while Edwards, Nimalendran, and Piwowar[4] determined that increased transparency was particularly beneficial for bonds with limited liquidity.

Based on our understanding that enhanced transparency following introduction of TRACE improved liquidity for corporate bonds, it is reasonable to expect that a reversal of transparency may lead to a decrease in corporate bond market liquidity.

2. ***Are there differences in block trading between groups at the threshold where the dissemination is delayed or the dissemination is delayed with increased cap? In particular, does a decrease in transparency:***
   1) increase the frequency or size of block trades;
   2) decrease liquidity in block trades; or
   3) increase the time between block trades?

As noted previously, we believe it likely institutional investors will wish to take advantage of the Proposed Pilot's dissemination delay to trades large blocks. But, as also noted earlier, we are uncertain how other investors, including potential block-trade counterparties, will respond to the changes. And more importantly, we expect the integrity of the corporate bond market pricing to erode due to the 48-hour delay in reporting of large block trades.

3. ***Is either dissemination delay or a delay with increased cap associated with changes in trading costs for investors? In particular, does a decrease in transparency:***
   1) decrease transaction costs (dealer roundtrip costs); or
   2) decrease costs from adverse selection (price impact)?

Based on the academic research around TRACE's launch, greater transparency, not reduced transparency, was shown to reduce trading costs. Bessembinder and Maxwell[5], for example, estimated cost reductions for TRACE-eligible bonds approaching 50 percent, together with narrowing of bid and offer spreads by about half, or 8 bps due to greater transparency.

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[3] Markets: Transparency and the Corporate Bond Market (Bessembinder and Maxwell) (2008).
[4] Corporate Bond Market Transparency: Liquidity Concentration, Informational Efficiency, and Competition (Edwards, Nimalendran, and Piwowar) (2006).
[5] Besembinder and Maxwell

Moreover, they found bid margins fell by 20 percent even on bonds with unreported prices due to the improved comparability provided by the more-transparent public market.

Goldstein, Hotchkiss, and Sirri[6] also noted that spreads on triple-B-rated bonds fell due to TRACE-mandated disclosures when compared with similarly rated bonds that did not have changes in transparency requirements. The authors determined that investors could negotiate better deals when they were armed with better pricing data provided by TRACE.

4. ***Is either dissemination delay or a delay with increased cap associated with changes in dealer behavior? In particular, does a decrease in transparency:***
   1) increase market making (measured as volume or inventory) of large broker/dealers that are active in blocks;
   2) benefit large broker/dealers that are active in blocks at the expense of less-informed ones in trades where block traders have an information advantage after the block executes but before that transaction is disseminated; or
   3) increase the probability of gaming by dealers, for example, altering their trading pattern to selectively release prices or make information more asymmetric?

In our view, any increase in market making is likely dependent on the interest of institutional investors to try to execute more large block trades. As we stated previously, we would expect some institutions to test whether the new rules lead to quicker and better block trade execution. At the same time, success will depend on the willingness of trade counterparties to engage in markets with significant, lengthy, and purposefully created information asymmetries that could make the best trading strategies look ill-informed in hindsight. Consequently, we are skeptical that market-making in large blocks will increase substantially.

As for the second part of this question, we expect that the parties privy to the best information about just-completed trades will be broker/dealers who may have executed block trades for institutional clients or were counterparties to competitors' working of similarly sized block trades. We expect that this, in turn will negatively affect the ability of investors to act as an initial buffer against lax execution, or even market abuse. FINRA, itself, had credited TRACE with enabling investors to "monitor the quality of price execution received on prior trades."[7] Without this type of transparency, regulators' ability to detect fraud, manipulation, unfair pricing,' misconduct and securities laws violations, among other malevolence, also may be impaired.

Greater transparency also is seen as having reduced dealers' information advantage over others in the market, helping spur changes in the market. Immediately after TRACE was launched, the 12-largest dealers' share of trading volume fell to 44 percent, from 56 percent before.[8] Conversely, it may be implied that reduced transparency will increase large dealers' share of the market to the detriment of smaller dealers, and retail and investors alike.

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[6] Transparency and Liquidity: A Controlled Experiment on Corporate Bonds (Goldstein, Hotchkiss, and Sirri) (2007)
[7] CFA Institute *2011 European Bond Markets Report*.
[8] Bessembinder and Maxwell.

5. ***Is either dissemination delay or a delay with increased cap associated with changes in dealer compensation? In particular, does a decrease in transparency:***
   1) ***increase the likelihood of principal activity relative to agency trades;***
   2) ***increase markups;***
   3) ***decrease the size of dealer networks; or***
   4) ***increase profitability of larger dealers at the center of the dealer network?***

   As noted previously, the introduction of enhanced disclosures through TRACE produced material declines in costs and pricing spreads. A decline in transparency, conversely can be expected to lead to reversals of these positive developments.

   An important element in these changes would come from investors, rather than dealers, however. Specifically, investors will have to compensate for the "known-unknowns" potentially created by one or more trades executed up to two days previous by adjusting their pricing. That the delays hide information about the largest trades, the potential effects for investors and traders alike could be significant.

   It is further likely that dealers will benefit from the potential for widened pricing spreads due to the delayed reporting of large block trades. In fact, the views of supporters of the Proposed Pilot impute an expectation of higher dealer returns when they opine that the reporting delay will encourage dealers to provide more block liquidity and thus enable dealers to recycle more of their block-trade risks. The implication from reducing dealers' difficulties is that they will earn more from managing block trade orders when the rest of the market is in the dark about what happened within the prior two trading days.

   We do not believe, however, these benefits outweigh the need for timely information about trades, including large block trades, of every other participant in corporate bond markets.

6. ***Is either dissemination delay or a delay with increased cap associated with increased adverse selection for less-informed institutional investors? In particular, does a decrease in transparency benefit more-informed institutional investors at expense of less-informed institutional investors?***

   There always will be some investors who are better informed than others, even under fully transparent conditions. The greater the transparency, however, the more likelihood that smaller or less-sophisticated investors will be able to mitigate or recognize poor execution quality or higher costs and therefore take steps to remedy these issues.

   Reduced levels of transparency, conversely, subjects investors to greater likelihood of fraud, poor execution, unfair pricing, and/or higher costs. Ultimately, such conditions lead to reduced investor trust in the markets, and poorer pricing.

7. ***Bond ETFs and bond mutual funds derive their value from an underlying basket of corporate bonds. Efficient pricing of these derivative baskets and their individual securities requires up-to-date information on the pricing of holdings. Is either a dissemination delay***

or delay with increased cap associated with more pricing errors in ETFs, mutual funds, or derivatives? Are these delays associated with profitable trading strategies for these instruments by market participants that trade blocks of securities that underlie the instruments and are subject to delayed dissemination? In particular, does a decrease in transparency:

1) decrease the accuracy of average ETF and mutual fund pricing;
2) increase the information content in ETFs and mutual funds associated with more-informed market participants relative to others; or
3) increase profitable trading of derivatives by dealers that trade blocks in corporate bonds?

We cannot imagine that delaying reports on large block orders can do anything but decrease the accuracy of ETF and mutual fund pricing for individual investors. We also see the dissemination delay enhancing the relative information disparity between investors and broker/dealers.

As expressed previously, we are greatly concerned with how the reporting delays will affect fund products. These instruments are increasingly the manner in which most individual investors indirectly get exposure to investment securities. According to the Investment Company Institute 2019 FactBook, investment companies managed slightly more than $4.0 trillion in corporate bonds,[9] equal to approximately 43.4% of the $9.2 trillion in total value of corporate bonds outstanding,[10] That is nearly twice the average 21% of their savings US investors have with investment companies.[11]

Given the importance that individual investors have placed on investment funds to invest their savings, pricing integrity is critical for these instruments. Keeping key pricing data from mutual and exchange-traded funds will prevent accurate and timely NAV calculations for these instruments and their investors, thus spreading the loss of market integrity and investor trust beyond the corporate bond market and to a significant and growing segment of fund investors.

Conclusion

As stressed in the above discussion, it is our view that the imposition of a 48-hour delay in reporting on what some have estimated at one-third of total corporate bond trades will harm investors, create pricing distortions, and impair bond market integrity. This is contrary to our regular support of pilot programs to test how certain regulatory changes may or may not affect market operations and behavior. Given the problems such a delay would create to most market participants, however, we urge FINRA to refrain from implementing the Proposed Pilot as proposed with the 48-hour delay. A pilot testing the higher caps for disclosure of parties and the full size of trades greater than the existing cap nevertheless would be acceptable. Should you have any questions about our positions, please do not hesitate to contact Kurt N. Schacht, CFA at

[9] See Table 3 (https://www.icifactbook.org/deployedfiles/FactBook/Site%20Properties/pdf/2019/19_fb_table3.pdf) and Table 11 (https://www.icifactbook.org/deployedfiles/FactBook/Site%20Properties/pdf/2019/19_fb_table11.pdf).
[10] See SIFMA US Quarterly Highlights 4Q'18, slide 5: Outstanding – 3Q'18 (https://www.sifma.org/wp-content/uploads/2019/01/US-Quarterly-Highlights-2018Q4-2019-01-11-SIFMA.pdf)
[11] See Figure 2.3. https://www.icifactbook.org/ch2/19_fb_ch2

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Sincerely,

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/s/ James C. Allen

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