

June 11, 2019

Via Electronic Mail

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

Re: FINRA TRACE Pilot Proposal

Dear Ms. Asquith:

Credit Suisse Holding (USA), Inc. ("Credit Suisse") appreciates the opportunity to provide the Financial Industry Regulatory Authority ("FINRA") with comments in response to the notice seeking public comment (the "Notice") on the proposed pilot program intended to study changes to corporate bond block trade dissemination, based on recommendations of the Securities and Exchange Commission's ("SEC") Fixed Income Market Structure Advisory Committee ("FIMSAC or Committee").¹

We commend FINRA for the reasonable steps taken to assess the impact of an increase to the current dissemination caps for corporate bond trades and delayed dissemination of any trade information above the proposed dissemination cap. We are supportive of a pilot program that is designed to address our concerns around the decline in block liquidity and its impact on market participants. The broker dealer community, who have historically traded large size transactions, have shifted away from executing such transactions moving to smaller size on average, particularly for less liquid and lower rated bonds, and adjusting their price accordingly to reflect the cost of near-immediate transparency as mandated under the current regime. This has effectively taken liquidity out of the market that could otherwise be made available to institutional investors.

As a liquidity provider to buy-side counterparties with significant levels of assets under management that need to be liquidated or purchased, it is critical for the broker dealer community to effectively manage their funds and investments by facilitating such activity in the most cost-effective, efficient, and market-responsive manner. We have seen a decline in the proportion of block trades to total volume notwithstanding an increase in the average and median size of corporate bond new issues merely due to the fact that the current price transparency regime has made it substantially more difficult to execute block size transactions without having to break the large trade into several (or more) smaller size trades in order to lay off the large size risk without moving the market.

The goal of the pilot program is to elicit maximum useful data such that clear driver(s) to the decline in block liquidity are identified and, therefore, can be addressed by FINRA. As such, we believe that the proposed pilot program is too complex and should be simplified in order to prove or disprove the assertion. Section 1 of this letter further explains our approach with an alternative proposal and supporting rationale for FINRA's consideration. Section 2 of this letter offers specific comments to

¹ FINRA's Regulatory Notice 19-12, "FINRA Requests Comment on a Proposed Pilot Program to Study Recommended Changes to Corporate Bond Block Trade Dissemination."

the research questions included in the Notice, which have been raised to determine whether or not the proposed pilot program can provide a reliable outcome.

Section 1: Observations on the proposed pilot program and an alternative suggestion

We believe that the four populations contemplated by the pilot program (i.e., the proposed test groups and a control group) cause the pilot program to be too complex to be useful. In practice, the requirement to reference one of the four groups on a security-level basis means that FINRA member firms must simultaneously consider the impacts of four different disclosure regimes while pricing a bond, which is an extremely laborious process and which would inhibit change. The results will, therefore, be inconclusive, causing the pilot program to fail to prove or disprove the assertion.

The pilot program would produce more meaningful results if it was simplified in the following ways:

- Maintain the dissemination caps for corporate bond trades as they currently are (i.e., no change).
- Define “Super Block” trades as those involving [volumes] which are greater than or equal to \$25mm for investment grade (“IG”) and greater than or equal to \$10mm for high yield (“HY”).
- Delay dissemination of “Super Block” trades for 48 hours.
- Divide the market into one test group and one control group.
- Divide the market equally, using the full population, between odd and even CUSIP numbers.
- Switch the test group and control group halfway through the pilot program and extend the duration of the pilot program to a full 18 months from the proposed [12 months].

In our opinion, these “Super Block” trades are infrequently being traded today, except on very liquid jumbo issues. Therefore, introducing a 48-hour delay would not decrease transparency. Rather, such a delay would create new liquidity for transactions of a larger size as broker-dealers look to liquidate those block trades into smaller sized transactions during the dissemination delay which get reported as soon as practicable thereby increasing block liquidity and increasing transparency in the market.

As a consequence to increasing the “Super Block” size and delaying it by 48-hours, it is our assertion that this would not create adverse selection to institutional investors or FINRA member firms. Smaller issuers are less likely to be transacted in block size meeting the higher dissemination thresholds, equally, smaller investors are less likely to be transacting in size which would meet the current and/or proposed higher dissemination caps; therefore, we can assume that the large broker-dealers who already have the risk appetite and capacity to transact in large size blocks, will merely be better positioned to service their institutional investors with whom the flows are already concentrated (yet not fully optimized).

We do not expect any material impact on trading as a result of a change in dissemination caps (from \$5mm to \$10mm and from \$1mm to \$5mm for IG and HY, respectively). Therefore, market testing at the end of the pilot program is not required.

Finally, the proposed alternative pilot program is expected to provide evidence that will result in an increase in trades classified as “Super Block” trades, as defined in this letter. As large investment managers take advantage of the available liquidity for larger size transactions, the dissemination delay should also serve to reduce price volatility and should promote a more orderly market that could be expected to be reflected in both the quantitative data results and qualitative feedback from the investment manager community.

Section 2: Comments to research questions [1-7] from the Notice

1. Trade-based

Is 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;*
- 4. decrease uncertainty/error in prices?*

Dissemination delay or a delay with increased cap associated with changes in aggregate trading activity (resulting in less transparency) will increase the frequency and size of block trades, which will in turn positively impact liquidity. This positive cycle is driven by the fact that clients will be considerably more willing to trade blocks knowing that they can achieve greater liquidity with the delay in Trade Reporting and Compliance Engine (“TRACE”) reporting, which, in turn, incentivizes the broker-dealers to do the same. Specific, real life examples include the following:

- An IG trader (the “Trader”) sells \$20mm of in Company XYZ 7.625 26 at a price of 106.5 to a client (the Trader is marked at 105.5-106). The client could have bought up to \$50mm, and the Trader may have sold that at 106.5 or 106.75. However, knowing its competitors will offer a price around 106.5 in the absence of time to be the best bid and to recover their risk, the Trader is inhibited from otherwise providing more liquidity (and is less likely to do so on a regular basis).
- When the market is moving wider and a key franchise client wants to sell approximately \$17-20mm in bonds of a high beta name, the broker-dealer is motivated to pay a wider level to minimize the trace print to go up in size despite the client looking for a price closer to the bid price (for the specific credit trading -10pts wider on the day), which could be better supported, particularly in volatile markets with a 48-hour delay of all trades.

2. Blocks and block activity

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;
3. increase the time between block trades?

Refer to Company XYZ example above.

3. Trading costs

Is either a 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 (e.g., dealer roundtrip costs);
- 2. decrease costs from adverse selection (i.e., price impact)?**

Portfolio trading is also a theme in the market. Sometimes a big sized trade is executed and when the market learns about this, trading will stop for a given bond until it spots that day. Therefore, a 48-hour delay could help these broker-dealers achieve greater liquidity at current levels.

4. Dealer behavior

Is either a 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 expense of less informed ones in trades when block traders have an information advantage after the block executes but before that transaction is disseminated;
3. increase the probability of gaming by dealers, for example, altering their trading pattern to selectively release prices or make information more asymmetric?

A decrease in transparency will increase market-making ability of large broker-dealers. It will benefit large broker-dealers who are active in blocks and it will increase the incentive for providing liquidity. Since customers will be trading larger blocks due to the delay, larger dealers will be trading in greater volumes and increasing the velocity of inventory. For example, if the Trader sells \$50mm with Company XYZ trading +1pt, his bid will be much higher than the bids of his competitors, and such Trader will bring a substantial majority of the selling through such Trader's desk. When providing that liquidity, the main concern is around finding enough supply at that price level to cover our risk.

5. Dealer compensation

Is either a 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;
4. increase profitability of larger dealers at center of the dealer network?

A decrease in transparency will increase principal trading in size, rather than orders being priced at current market levels. Therefore, a dissemination delay or a delay with increased cap will not necessarily be more profitable for broker dealers provided that traders evaluate the correct liquidity premium for the size.

6. Buy side behavior

Is either a 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?

Neither a dissemination delay nor a delay with increased cap is likely to introduce adverse selection favoring more informed investors at the expense of less informed institutional investors. The more informed (larger) buy side accounts usually are permitted to see the block trades sooner. However, all clients still have access to symmetrical information and the ability to see enough in the markets to have an informed view regarding the price at which bonds should trade.

7. ETFs, mutual funds and derivative markets

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?*

In our opinion, these "Super Block" trades are infrequently being traded today, except on very liquid jumbo issues. Therefore, introducing a 48-hour delay would not decrease transparency. Rather, such a delay would create new liquidity for transactions of a larger size as broker-dealers look to liquidate those block trades into smaller sized transactions during the dissemination delay which get reported as soon as practicable thereby increasing block liquidity and increasing transparency in the market.

We thank FINRA for consideration of our comments. If you have any questions, please do not hesitate to contact Warren Young (warren.young@credit-suisse.com) or Jessica Mandel (jessica.mandel@credit-suisse.com).

Sincerely,



David Miller
Global Head of Credit