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

Transmitted by email to pubcom@finra.org

Comments on FINRA Regulatory Notice 19-12, "Trade Reporting and Compliance Engine (TRACE)"

Dear Ms. Asquith,

The Bond Dealers of America (BDA) is pleased to provide comments on FINRA Regulatory Notice 19-12, "Trade Reporting and Compliance Engine." BDA is the only DC-based group exclusively representing the interests of securities dealers and banks focused on the U.S. fixed income markets.

Notice 19-12 proposes to implement a one-year pilot program (the "Pilot") to test changes in dissemination of corporate bond trade information on corporate bond market liquidity. Although it would be merely a pilot program, the proposal would significantly alter the way corporate bonds trade and would provide advantages and disadvantages to categories of market participants. It would also seriously erode the level of transparency in the corporate bond market and in doing so would disadvantage institutional and retail investors.

BDA's members include many dealers who serve as corporate bond liquidity providers. BDA's members active in the institutional market tend to focus mostly, but not exclusively, on small to medium size customers. BDA's members employ a variety of business models, but generally BDA firms trade with both large dealers who would most benefit from changes proposed in the Pilot, and institutional and retail investors. In that respect, BDA's members are both providers and consumers of market liquidity.

BDA's members often cover institutional investors that are smaller and less sophisticated than the biggest "Tier 1" accounts. These investors have fewer resources and less access to market information and are generally more dependent on dealers for market data and intelligence. These types of institutions would be more severely affected by the loss of transparency associated with the Pilot's proposed 48-hour dissemination delay than larger customers. Many BDA members also service retail customers. While retail does not typically trade in block sizes, they would also be negatively affected by the Pilot, since less transparency would mean less accurate price quotes and less accurate compliance and valuation systems.

BDA opposes the implementation of the Pilot. We believe no compelling case has been made that such an attack on transparency is warranted, and there is no indication that the steps FINRA is proposing would have any positive impact on liquidity. The 48-hour dissemination delay for trades in test groups 1 and 3 would significantly reduce the level of market transparency to the detriment of institutional and retail investors and many dealers. If FINRA does move forward with the Pilot, we urge significant changes to the structure of the proposal in order to protect investors and maintain market integrity. In this letter we address some of the specific questions FINRA raises in Notice 19-12.

Q: Is there a need for this pilot? What evidence can you provide to support this conclusion?

A: BDA members are not convinced that there is a "liquidity problem" in the corporate bond market. It is true that large blocks are harder to trade than small blocks. It is also true that in times of market stress, corporate bond market liquidity wanes. However, it is not obvious that these observations reflect a market failure. Arguably it *should* be harder to execute large blocks than small, and liquidity *should* drop in a stressed market. Indeed, waning liquidity is practically the definition of a stressed market. Liquidity comes with a cost, and in almost all circumstances, liquidity is available if market participants are willing to pay for it. Unless much more compelling evidence of a market failure surrounding liquidity is presented, there is no justification for implementing the Pilot. Indeed, the Pilot will likely have the consequence of diminishing liquidity in cases where dealers are unwilling to commit capital on the basis of opacity in disseminated trade data.

Q. Are there particular risks, economic or otherwise, inherent in a pilot that reduces transparency that already exists in the marketplace?

A. The biggest deficiency with the proposed Pilot is the provision to withhold trade reports entirely for 48 hours for test groups 1 and 3. Not disseminating any information for those trades for two trading days would introduce significant opacity to the market. In a situation where a dealer has acquired a large block of bonds in an undisseminated trade, market participants would see offerings associated with the dealer liquidating the block position in smaller pieces without knowing that there may be a significant volume of additional bonds of the same CUSIP behind the offering, which is an important factor affecting pricing. Withholding this trade data would also have negative ramifications on functions like bond valuation services, which depend on that day's trading data to estimate values for bonds that did not trade that day. As you know, many market participants are required by regulation to value their or their customers' portfolios daily. We discuss these concerns in more detail below.

Q. Are there ways market participants can alter their behavior during the course of the pilot to affect its outcome? What changes can FINRA make to the pilot design to limit or mitigate the impact of such "gaming?"

A. When an investor is seeking a bond for their portfolio, it is sometimes the case that they are looking for a bond with particular characteristics, not necessarily a specific issuer or CUSIP. This is sometimes the case for high-grade utility issuers, for example. An investor may be seeking a double-A rated bond with a 10-year duration from a large utility issuer. Various bonds that satisfied these criteria might be acceptable to the customer. It is possible that a dealer or investor could focus their search on just those bonds within one or more test groups or the control group in order to ensure that their trade is or is not disseminated in real time. In most cases, however, bonds trade based on issuer name and credit and are much less substitutable.

Q. Is the pilot adequately designed with respect to its objective?

A. We believe the Pilot would provide evidence of the potential consequences of permanent rule changes on market liquidity. However, as described throughout this letter, that evidence would come at the expense of market participants who would be disadvantaged under the Pilot.

Q. Are Test Groups 1, 2 and 3 clearly defined?

A. They are clearly defined. However, the proposal is unclear about the overall scope of the Pilot. Would it encompass the entire corporate bond market, or would FINRA segregate a portion of the market to serve as the universe of CUSIPs for the Pilot? If FINRA moves forward with the Pilot, we urge you to apply the proposal to the entire universe of eligible bonds. Having part of the market subject to the Pilot and part not would magnify opportunities to game prices based on the opacity imposed by the Pilot.

Similar bonds tend to trade similarly. Having access to undisseminated trade information would give market participants an advantage not only with respect to those CUSIPs or issuers' bonds. It is valuable market intelligence that could also be applied to trades in other CUSIPs both in and out of the test groups.

Q. Is it appropriate to have a market-wide pilot or should it be limited to a small number of CUSIPs?

A. The BDA opposes the Pilot for the opacity, skewing valuations, and competitive disadvantage reasons listed throughout this letter. However if the Pilot moves forward in any form, it should encompass the entire market.

Q. Should all of the CUSIPs in each test group be published or should some or all not be made known?

A. It is very important that FINRA publish which CUSIPs are included in the Pilot and which test group each CUSIP is in. Doing otherwise would be confusing. That information would be known soon enough as market participants observed the way individual trades are disseminated. In the interest of transparency and to minimize informational asymmetry, we urge FINRA to publish all CUSIPs subject to the Pilot and in which test groups they have been assigned.

Q. Does the pilot propose to use the most appropriate outcome measures? If not, which ones are preferable and why?

A. The SEC's Fixed Income Market Structure Advisory Committee, in its recommendation to the SEC to move forward with a TRACE pilot program, identified a number of liquidity measures, including average daily trading volume of capped and uncapped trades, the number of capped and uncapped trades, the proportion of volume in block trades, the price impact of block trades, transaction cost analysis, and changes in dealer capital, inventory and behavior. FINRA Regulatory Notice 19-12 discusses additional, related metrics including dealer round-trip transaction cost. We believe these metrics would provide as clear a picture as possible of liquidity conditions. However, we also point out that in the corporate bond market, continuous, two-way quoted prices exist for the most liquid and actively traded CUSIPs. Actual, real-time bid and ask quotes for less liquid CUSIPs do not exist in our market and must be imputed mathematically.

Q. Are there other methods that could be used to determine the control and test groups? For example, should the corporate bonds be assigned to the control group and test groups by a more random approach—such as based on the last digit of the CUSIP for each bond, instead of assigning bonds to groups based on the stratification characteristics like those discussed above (size of issue, age of issue, rating and 144A status)?

A. FINRA has proposed to use stratified sampling in selecting CUSIPs for each test group. We agree with this approach if the Pilot moves forward. We do not believe that selecting CUSIPs randomly would yield as useful results because it is likely that the test groups would not necessarily reflect the breadth of the corporate market and would not include an appropriate combination of the selection dimensions you have identified.

While as we stated we oppose the Pilot outright, if FINRA moves forward with the proposal, we urge you to segregate the test groups such that all of an individual issuer's bonds are in a single test group. Bonds of the same issuer often trade similarly. Splitting an issuer's bond issues or individual CUSIPs among the test groups would exacerbate the economic externalities associated with the loss of market transparency.

FINRA should consider executing the Pilot with sequential, rather than simultaneous, test groups. Under this scenario, each of the changes to dissemination rules would be implemented by itself, with just a single test group and a control group. When testing of the first group is complete, the test implementing the next rule change would begin. This way there would be less risk of market disruption, and the effects on each test group could be better isolated.

Q. Is there a risk that traders can easily substitute CUSIPs in a test group for ones in the control group? If so, to what extent might this happen and on which dimensions (*e.g.* CUSIP from the same issuer, CUSIP from a different issuer having the same maturity and age)?

A. As discussed above, in some cases there is a risk that traders can substitute CUSIPs in a test group for ones in the control group and vice versa. Some high-grade corporate bonds, such as those issued by utility companies, are sometimes substitutable. Traders would simply direct their activities to CUSIPs that meet their criteria for investment and are also in the test group that meets their dissemination preferences. In most cases, bonds trade individually - based on credit quality and other factors - and are not easily substitutable. It is likely that if a trader were going to direct their activity to CUSIPs in one or more test group or the control group, they would base decisions on dimensions such as credit quality, maturity, industry of issuer, and others. Two double-A rated, 10-year electric utility bonds from different large issuers may not be perfectly substitutable, but they may be substitutable enough to affect a trader's investment decision under the Pilot.

Q. Will market participants and other users of the TRACE data need to make any system changes as a result of the pilot? For example, will pricing, compliance or other systems, including systems used to determine or supervise prevailing market price for fair pricing and calculating mark-ups for retail and other customers, need to be updated to reflect delayed dissemination of certain trades? If so, how long will those changes take to implement and what would be the estimated costs associated with such changes?

A. We believe the Pilot could reduce the effectiveness of certain compliance systems dealers have in place in a way that would be particularly harmful to retail investors. Addressing those issues would potentially impose costs, but it is not clear that the issues even could be adequately addressed due to the reduced trade data that would be available under the Pilot.

Systems designed to assist in compliance with markup, best execution, and portfolio valuation rules depend heavily on daily trade data. Withholding trade information for up to one-third of the corporate market (test groups 1 and 3 together if the Pilot were implemented across the entire market) would remove a significant volume of data from the systems used to determine prevailing market price (PMP) and appropriate markups, estimate bond valuations, and potentially other functions. These rules and compliance functions are aimed mostly at protecting retail investors, and so any erosion in dealers' ability to accurately comply with those rules would disadvantage retail customers especially. So the issue is likely not "how long will those changes take to implement?" The issue is that with less trade data available, compliance systems would be less accurate. We do not see a way to address this within the structure of the proposed Pilot.

Dealers would also face compliance issues with respect to research. Many firms publish bond research targeted at both retail and institutional customers. There would be an apparent conflict where a firm executed a trade, that trade had not been disseminated under the Pilot rules, and a firm published a research opinion on that security. Since research analysts may gain access to information on undisseminated trades, this issue would need to be addressed by guidance. Would an analyst's knowledge of an undisseminated trade prevent her or him from publishing research on that CUSIP? Should the research supervisor be told about the undisseminated trade in the CUSIP that is the subject of a research piece? Can information barriers be expected to work effectively in this context?

Q. With respect to the 48-hour dissemination delay (*i.e.*, Test Group 1), have its benefits or costs be adequately described?

a. **Will the 48-hour dissemination delay improve liquidity for those trade sizes affected? If so, would transaction costs decline, or trade sizes or dealer inventory increase? Would buy-side firms need to contact fewer dealers for quotes?**
b. **Would traders that do not typically trade the sizes affected by the dissemination delay be negatively affected by the informational asymmetry? If so, how?**
c. **Would delayed reporting have an amplified effect on securities deriving their value from corporate bonds leading to ineffective pricing of index-based products, such as ETFs, and derivatives, such as total return and credit default swaps?**
d. **Would the reduced price transparency caused by the 48-hour dissemination delay have particular impacts on retail investors, for example, by reducing the market information used to determine prevailing market price for fair pricing and to calculate mark-ups?**

A. The 48-hour dissemination delay is the most troublesome aspect of the Pilot. Withholding data completely on a significant number of trades would have unpredictable behavioral consequences and would result in significant informational asymmetry. It would disadvantage some market participants relative to others. The enhanced transparency associated with raising trade size caps would not balance the loss of transparency associated with holding trades for test groups 1 and 3 for 48 hours. It is highly likely that some investors would receive off-market prices on bond trades due to lack of information.

Consider an example where a dealer buys a large block of high-grade bonds included in test group 1 or 3 from a customer. That trade is above the trade size mask, so the trade is not disseminated in real time but held for 48 hours. The dealer who now owns the large block begins offering the bonds in smaller sizes to investors and other dealers. Those traders do not know that the dealer making the offering also owns a significant volume of the same CUSIP that will also be offered to the market over the next two days. That fact is significant with respect to establishing the value of the bonds, and not having that information is a significant disadvantage for those whom the block dealer seeks to trade with. In addition, the dealer's sales of portions of the position would likely occur at least in part in sizes below the trade size masks, so those trades would continue to be disseminated in real time. Other traders would see the sales of small blocks but not the acquisition of the large block.

The Pilot is silent on some questions associated with dealers who execute trades that would be subject to the 48-hour delay. Presumably those dealers could hedge their positions, continue to buy more of the same CUSIP, sell bonds from the undisseminated block, and otherwise operate normally in the market. If FINRA moves forward with the Pilot, we ask that you clarify those issues.

Also, large blocks sometimes trade outside the bid-ask spread prevailing for smaller trade sizes. After the 48 hours expires and the withheld trades are publicly disseminated, investors or dealers who bought bonds during the 48-hour opacity window could find their positions are worth something different that what they expected or paid. This puts small and medium size dealers' capital at risk simply due to lack of trade information.

Moreover, it is not true that the undisseminated trade information would be unknown to the market. It is certainly known to the two parties to the trade and it is known to whomever those parties told. Undisseminated trade information does not represent material nonpublic information ("MNPI") for the purpose of insider trading laws and regulations. However, it is qualitatively similar to MNPI in that it reflects informational asymmetry that could be used to manipulate market prices.

FINRA has addressed a similar issue previously. FINRA Rule 5270, "Front Running of Block Transactions," prohibits FINRA members from executing "an order to buy or sell a security or a related financial instrument when such member or person associated with a member causing such order to be executed has material, non-public market information concerning an imminent block transaction in that security." Under the Rule, "Information as to a block transaction shall be considered to be publicly available when it has been disseminated via a last sale reporting system," or similar specified platform. FINRA clearly had in mind informational asymmetry associated with block transactions when it implemented this rule. Those same concerns apply with respect to the Pilot.

As stated, we believe the 48-hour trade delay would negatively affect retail investors by reducing the availability of key information used for the purpose of determining prevailing market price, end-of-day valuations and other compliance functions.

Q. With respect to the increased dissemination caps (*i.e.*, Test Group 2), have its benefits or costs been adequately described?

a. **Would the increase in the reporting cap size mitigate the informational advantage accruing to dealers and institutional investors who trade blocks created by the 48-hour dissemination delay? If so, would smaller dealers step in and begin providing quotes for trades having benefited from the increased reporting cap?**
b. **If trade sizes do increase in response to the increase in the reporting cap size, are traders more likely to trade blocks with qualifying size rather than the typical smaller blocks or blocks broken into smaller pieces?**

A. The increase in the reporting cap size would not mitigate the informational advantage accruing to dealers and institutional investors from the 48-hour dissemination delay. We do not believe raising the trade mask sizes would have a significant effect on smaller dealers, many of whom are BDA members, on providing quotes. Broker-dealers of all sizes already provide significant support for market liquidity, and we do not believe the Pilot's changes to trade size masks would affect that significantly.

By raising the trade size masks and applying those higher masks to the 48-hour delay as in test group 3, the Pilot would advantage larger dealers relative to smaller dealers. As some FIMSAC members stated in a letter opposing the FIMSAC's pilot recommendation, "information is power, and power produces profits."[1]

Liquidity for small institutional investors works in much the same way as for larger investors and depends on dealers committing capital to market making. However, smaller and mid-size dealers do not frequently execute blocks larger than the trade size masks. There is no advantage or incentive in the Pilot for smaller dealers whose trades are mostly below the trade size masks to enhance their provision of liquidity and nothing in the Pilot to address the risks smaller dealers face when carrying inventory.

The 48-hour delay in any trade information whatsoever being disseminated to the market is a significant flaw in the Pilot that would result in information asymmetry to the advantage of certain market participants at the expense of others. Nothing else in the Pilot design would fully mitigate that concern.

We generally agree with the criticisms of the 48-hour delay outlined in the Harris letter. We agree, for example, that "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." We also agree that "that the market structure should [not] favor large traders to the detriment of smaller traders."

Q. Should FINRA consider other potential designs, for example, as described in the Harris Letter? If so, what designs should be considered and how do they improve over the design described here?

A. We believe there is merit in revising the Pilot along the lines suggested in the Harris letter. We certainly agree that the 48-hour dissemination delay is a deficiency in the Pilot design that should not be implemented. We also agree that lowering, not raising, the trade size masks would be a better approach to enhancing liquidity without disadvantaging any market participants relative to others or to current rules.

[1] Letter from Larry Harris, Fred V. Keenan Chair in Finance, USC Marshall School of Business, Kumar Venkataraman, James M. Collins Chair in Finance, Southern Methodist University, and Elisse Walter, Former Chairman, SEC, to Brent J. Fields, Federal Advisory Committee Management Officer and Secretary, SEC, August 21, 2018 ("Harris letter").

We also point out that in cases of crosses or "riskless principal" trades above the trade mask thresholds where a dealer buys and sells the same block simultaneously, trade data would remain undisseminated for 48 hours for test groups 1 and 3 even though the dealer took no market risk in the transaction. If FINRA moves forward with the Pilot, we do not recommend addressing this issue since an automated fix would likely result in some "false positives" for riskless trades and a manual fix would mandate that dealers self-identify crosses, which would be impractical and expensive.

While we agree that the notion of a pilot program is preferable to simply implementing changes to dissemination rules, we do not agree with the structure of the Pilot as proposed and we urge FINRA to abandon the proposal. The 48-hour dissemination delay would have too negative a consequence on market transparency and would create severe disadvantages for those to whom key market data are not available for two full trading days. Liquidity conditions in the corporate market are not so severe to justify such a step.

We urge FINRA to abandon the proposal. If FINRA chooses to move forward with the Pilot over our and others' objections, it is important that certain changes be adopted to address risks the Pilot would impose. We have additional thoughts on ways to mitigate the damage from the Pilot if FINRA moves forward, and we would be happy to discuss those recommendations. However, we continue to urge FINRA to withdraw the Pilot proposal.

Thank you for the opportunity to submit these comments.

Sincerely,

Mike Nicholas
CEO
Bond Dealers of America