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June 3, 2019

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

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

Dear Ms. Asquith:

I appreciate the opportunity to comment on FINRA's Proposed Pilot Program to Study Recommended Changes to Corporate Bond Block Trade Dissemination. FINRA proposed this study following the recommendation of the SEC's Fixed Income Market Structure Advisory Committee ("FIMSAC") of which I am a member.

I write today in my name only. My comments represent my opinions only and not necessarily those of any of my FIMSAC colleagues, Interactive Brokers for whom I serve as lead independent director, any of the mutual funds for which I am a director or trustee, or my employer USC. Moreover, none of these entities have reviewed or in any way limited my comments.

I dissented from the FIMSAC recommendation. Comments on the recommendation that Kumar Venkataraman and Elisse Walter and I submitted to the SEC FIMSAC file are attached. I continue to fully endorse these comments. Please consider them to be an integral part of this comment letter.

I strongly oppose delayed reporting of trade prices for large corporate bond trades. The proposed pilot study will impose substantial costs on investors, particularly retail investors. I do not believe that it will produce new information of any value to policymakers. Moreover, other much cheaper research methods can produce valuable information that bears on the question.

The Rationale for the FIMSAC Recommendation

The FIMSAC recommendation seeks to protect large dealers from front-running when taking a large position to accommodate large selling clients. Dealers arguing for the proposed decrease and price and size transparency for large trades assert that other traders front-run their positions when they see TRACE-reported trades that indicate that some dealer has taken a large position into inventory.

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This assertion is easily tested. Using the TRACE data identified by dealer (available to FINRA in real time and to academic researchers on a delayed basis), researchers easily can determine whether net selling by other traders increases following a large dealer bond purchase, and in particular, whether the selling occurs before the dealer is able to liquidate the position. If the assertion is not valid, the rationale for the FIMSAC recommendation is not supported. The proposed pilot study certainly should not be undertaken before the results of this simple low-cost study are known.

Transparency

The degree to which trade prices are known is a primary determinant of transaction costs for uninformed investors. Such investors rely on transparent markets to determine the quality of the trade prices that they receive. This result is well known in all exchange and product markets and is strongly supported in studies too numerous to mention.

Of greatest relevance to the instant question are two studies that Amy Edwards, Mike Piwowar, and I executed while I served as Chief Economist of the SEC.[1] These studies examined data from the pilot studies undertaken by FINRA and the MSRB to determine whether to make the TRACE and EMMA trade price and size data publicly available. Our studies showed that transaction costs decreased for customers who traded bonds for which trade price and sizes were published.

These studies did not examine whether frontrunning increased following large dealer bond purchases for those bonds whose trade prices and sizes were displayed. Analysts can easily address this issue using the data which are still available.

Although the data are old (dating to 2002-2003), they are still relevant. Frontrunning strategies are as old as the markets. If the alleged front-running problem cannot be found in these data, little reason suggests that they would be found in data produced through the proposed pilot study. The proposed pilot study should not be undertaken before the results of this simple low-cost study are known.

The Alternative Explanation

Dealers undoubtedly would be better able to accommodate the demands for liquidity made by large traders if their large trades were not immediately displayed. Arranging subsequent inventory liquidating trades at prices favorable to the dealers would be easier when the receiving investors (generally smaller investors) are unaware of the initial block trade prices. The dealers

[1] See Harris, Lawrence and Michael S. Piwowar, "Municipal Bond Liquidity," *Journal of Finance*, v. 61 (3), June 2006, 1361-1397, and Edwards, Amy, Lawrence Harris, and Michael S. Piwowar, "Corporate Bond Market Transaction Costs and Transparency," *Journal of Finance*, v 62 (3) June 2007, 1421-51.

would profit at the expense of the receiving traders, and they probably would pass some of those profits on to their large block initiators.

Using data from the original TRACE and EMMA pilot studies, analysts can easily examine whether transaction costs to receiving investors following large block trades depend on price transparency. If the costs decrease with transparency, the costs of the proposed pilot study to smaller investors could be estimated. And with this information, regulators would be better informed about the benefits of transparency to smaller investors, and thus better able to trade-off their interests against the interests of larger better-informed investors. The proposed pilot study should not be undertaken before the results of this simple low-cost study are known.

An Alternative Proposal

TRACE reports both trade prices and trade sizes. The front-running rationale for the pilot study concerns only trade sizes. The benefits to uninformed investors of trade transparency come almost exclusively from price transparency. Accordingly, if trade transparency were to be decreased to prevent front-running, only trade sizes should be delayed and not trade prices. No reason suggests that prices cannot be published without sizes. Indeed, TRACE already publishes prices without full trade sizes for large trades.

Good public policy suggests that the pilot study should examine the minimal changes necessary to accomplish the goals of the FIMSAC recommendation. If a pilot study is to be done (which I do recommend), it should examine whether the markets would be improved by reducing only size transparency. Such a pilot study would examine whether a decrease in the full trade size reporting thresholds from $5 million for investment grade ("IG") bonds and $1 million for non-investment grade ("N-IG)" bonds to smaller values of say $2.5 million and $750,000 would provide the protections sought by the recommendation. Any pilot study undertaken should examine this question as it is the least cost approach to achieving the sought-after objective.

The FIMSAC recommendation increases trade size transparency for trades between $5 and $10 million for IG bonds and between $1 and $5 million for N-IG bonds. As noted in the attached comment letter, I do not believe that this increase in size transparency has much value to investors. The size of a trade confirms the price associated with the trade. The degree of additional confirmation associated with knowing that a bond trade is larger than $1 million cannot be significant because $1 million is a significant amount of money to all investors.

Riskless Principal Trades

Concerns about front-running do not apply to riskless principal trades because the dealers who broker these positions do not assume inventory risk. Accordingly, all such trades regardless of size should be subject to full and immediate price and size reporting. Any change in TRACE

reporting practices should recognize this distinction, which previously has not been applied in practice.

Although the FIMSAC recommendation did not address size reporting for riskless principal trades, the rationale for the recommendation addresses concerns about size disclosure risks to dealers. When addressing these risks, policymakers would be wise to acknowledge that riskless principal trades impose no such risks.

Since the exclusion of riskless principal trades from the proposed pilot would significantly complicate the study, it should not be a feature of the study. Instead, policymakers should require the full and immediate publication of price and size for all riskless principal trades.

The Pilot Study Design

Although I'm opposed to doing the pilot study, I want to commend FINRA on its design. The inclusion of a control sample is essential to obtaining meaningful results, and the assignment of three treated groups is essential to properly identifying the effects of the two recommended changes (delayed reporting of large trades and increased size reporting for intermediate size trades). Finally, rotating bonds among the groups halfway through the study period will help control for bond-specific effects and for fairness issues associated with group assignment.

The main omission in the statement of the study analysis objectives appears on page 16 under the section titled "3. Trading costs". The study should consider whether a decrease in transparency increases transaction costs to receiving investors. This object may be subsumed in other objectives, but its importance is so great that it must be separately identified and addressed.

Statistical limitations ensure that some analysis objectives will be difficult or impossible to achieve. For example, identifying effects on ETF and mutual fund pricing will be difficult given the short sample period and the impossibility of knowing true ETF and mutual fund values. The likely method will be to determine what effect the study has on the serial correlation of these prices over time. Unfortunately, the many factors that affect valuations also make accurate measures of serial correlations difficult.

That said, the theoretical effect of reduced transparency on pricing accuracy is obvious and impossible to contest: Pricing will be better when pricing is fully transparent. The extreme importance of accurate pricing of ETFs and mutual funds strongly suggests that the recommended policy change and its associated pilot study not be undertaken.

Attempts to identify the effects of transparency on adverse selection also will be inconclusive, and especially for investment grade bonds. Adverse selection comes from traders who know bond values better than others. Such knowledge may be based on better knowledge about interest rates or credit qualities. As most relevant interest rate information becomes public

knowledge within seconds, any significant adverse selection must come from knowing credit better than others. But the values of investment grade bonds do not depend nearly as much on credit issues than on interest rate levels. This observation plus the fact that estimates of adverse selection are imprecise under the best of circumstances suggest that effects concerning adverse selection will be inconclusive.

The Block Bond Market

The growth of electronic trading in the equity markets greatly reduced the importance of the block dealing in equities. Block initiators or their brokers increasingly use algorithms to break up their orders to reduce the costs of execution. They also now often use electronic crossing markets. Empirical studies confirm that that the all-in cost of trading of large equity blocks has decreased with the growth of electronic trading.[2]

The bond markets are now seeing substantial growth in electronic trading. Although bond markets are different from equity markets—primarily because bonds are more numerous than equities—they also will benefit from increasing electronic trading.

The FIMSAC recommendation seeks to protect an old way of doing business. Reducing price transparency to maintain incumbent dealers facing increasing competition from lower-cost players is unwise.

Finally, note that U.S. equity markets do not protect equity block dealers with delayed trade price reporting even though principal trades in equities are dollar-for-dollar riskier than those in the bond markets (because bonds are less risky than equities). In comparison to equity block dealers, bond block dealers are protected by trading less risky instruments. The fact that bond block trades often are larger reflects their low risk more than any inherent feature or need of bond market investors.

Conclusion

In the attached comment letter, my co-commentators and I argue that the TRACE dissemination policy should not be changed. In this letter, I argue further that no pilot study should be undertaken until the results of simpler, much less costly studies are known. I further argue that any study undertaken should address only the minimum changes necessary to achieve the objectives of the FIMSAC recommendation.

If I can be of further assistance to FINRA or the Commission on this issue, please do not hesitate to contact me.

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[2] See Angel, James, Lawrence Harris, and Chester Spatt, "Equity Trading in the 21st Century: An Update," *Quarterly Journal of* Finance 5 (1), March 2015.

Sincerely,

Larry Harris
Fred V. Keenan Chair in Finance
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cc:

Mr. Robert Cook, President, and CEO, FINRA
Mr. Jonathan Sokobin, Chief Economist, FINRA

The Honorable Jay Clayton, Chairman
The Honorable Robert J. Jackson, Jr., Commissioner
The Honorable Hester M. Peirce, Commissioner
The Honorable Elad L. Roisman, Commissioner

Mr. Brett Redfearn, Director, Division of Trading and Markets
Mr. S.P. Kothari, Chief Economist and Director, Division of Economic and Risk Analysis

Attachment:

Comment letter by Larry Harris, Kumar Venkataraman, and Elisse Walter, Fixed Income Market Structure Advisory Committee, SEC File No. 265-30, also available at https://www.sec.gov/comments/265-30/26530-4268151-173129.pdf