MEMO# 32517

June 10, 2020

Summary of SEC's Fixed Income Market Structure Advisory Committee Meeting

[32517]

June 10, 2020 TO: Equity Markets Advisory Committee
Fixed-Income Advisory Committee RE: Summary of SEC's Fixed Income Market Structure Advisory Committee Meeting

The SEC's Fixed Income Market Structure Advisory Committee (FIMSAC) held a virtual meeting on June 1, 2020[1] and adopted recommendations regarding

- internal fund cross trades;
- pre-trade transparency in the municipal securities market; and
- issuer-pay conflicts of interest in credit ratings.

The recommendations are summarized below. The FIMSAC also featured panel discussions on the role of bond pricing services and transparency in the corporate bond market for large size trades, both of which also are summarized below.

Recommendation on Internal Fund Crosses

The FIMSAC unanimously adopted a recommendation to update Rule 17a-7 under the 1940 Act to better facilitate cross trades in fixed income securities.[2] The FIMSAC recommends two changes:

- Clarify that custodial fees and trading platform or dealer fees related to cross trades can be paid. The rule currently specifies that no brokerage commission/fee or other remuneration can be paid except for "customary transfer fees," but does not specify whether this includes a custodial fee or a trading platform or dealer fee.
- Allow different methods that ensure a fair price is obtained in a cross trade involving fixed income securities. The rule currently requires a fixed income security to be executed at the "independent current market price," defined as a midpoint price determined through "reasonable inquiry." However, obtaining multiple bids and offers to determine that price is difficult in most instances.

The standard for obtaining a fair price would be met if an adviser uses one of two methods:

- **Independent Pricing Source**: an independent pricing source (*e.g.*, regulatory trade reports, aggregated dealer runs, trading platform data, or other independent services) that is subject to oversight. However, such sources would be permitted for crossing Level 1 and 2 assets only. To ensure robust oversight, an adviser would adopt an "independent price plus" method, *i.e.*, use of at least one other price confirmation input to determine the reasonableness of a price. An adviser also would adopt other policies and procedures to ensure that a vendor price reasonably reflects the "current market" price and that the cross trade benefits both funds.[3] Further, an adviser would be required to report each cross trade to TRACE or RTRS as applicable, with a flag designating the trade as an internal cross.

- **Electronic Trading Platform**: an electronic trading platform that has functionality designed to achieve fair pricing of cross trades. The subcommittee noted that platforms have functionalities such as competitive "request-for-quote" processes that would require an adviser to enter a bid or offer without seeing other competing prices. An adviser should adopt policies and procedures for selecting and using platforms.

Discussion

The panelists and several committee members expressed support for the recommendation. Director Brett Redfearn of the Division of Trading and Markets asked prospectively whether any constituency would oppose the recommendation. Some panelists believe that opposition would be unlikely, but one panelist suggested that consumer advocate groups may find that it does not sufficiently address adviser conflicts of interest.

Recommendation on Pre-Trade Transparency in the Municipal Securities Market

The FIMSAC unanimously adopted a recommendation that the SEC examine pre-trade transparency in the municipal securities market.[4] In doing so, the SEC should review relevant developments over the last 10 years, including

- the manner in which retail trades are executed;
- the roles played by market participants, including intermediaries and marketplaces; and
- the manner and breadth of information dissemination to retail investors.

The SEC should also consider whether there are effective actions that the Commission, MSRB or others could take to provide additional transparency.

Discussion

Committee members briefly discussed the challenges of promoting pre-trade transparency in the municipal securities market. One committee member noted that municipal securities trade less frequently and have pricing that is affected by macroeconomic factors. Other committee members observed that investors have difficulty obtaining proper information, including adequate information on the issuers, to develop a reasonable idea of price. Another committee member observed that firm pricing often does not exist and forcing pre-trade transparency could disincentivize liquidity. In response, another committee member believes that indicative pricing is still useful and incentives should be considered to promote transparency of that information.

Recommendation on Conflicts of Interest in Credit Ratings

The FIMSAC adopted recommendations to mitigate potential conflicts of interest associated with current "issuer-pay" credit ratings model.[5]

As adopted, the FIMSAC provides three recommendations to the SEC:

- **Increased NRSRO Disclosure**: NRSROs should disclose more in-depth information about their rating models, including how those models differ by industry.
- **Enhanced Issuer Disclosure**: The SEC should work with trade groups to develop a set of best practices for corporate issuers when choosing NRSROs, including requiring issuers to disclose in their annual reports if and/or why they deviate from those practices.
- **Bondholder Vote on "Ratification" of Issuer NRSRO**: The SEC should consider a "ratification" mechanism for issuer-selected NRSROs. This mechanism would allow bond holders to conduct a vote of confidence on the issuer's choice of NRSRO.

Discussion

One committee member expressed support for vote ratification because it could serve as a disciplining mechanism and give buy-side participants similar power to the issuers in the selection of NRSROs. One committee member, however, voted against the recommendation and believes that vote ratification may have unintended consequences, *e.g.*, create an undue burden on bondholders.

Panel Discussion on the Role of Bond Pricing Services

The ETF and Bond Funds Subcommittee moderated a panel discussion of the role of bond pricing services, particularly during the market volatility that occurred in March and April.

Mark Heckert of ICE Data Services stated that ICE relies on different inputs to inform pricing information and seeks to provide "continuous pricing" throughout the day. During the March and April market volatility, ICE observed wider bid-ask spreads across all markets, with no consensus on valuations for similar products.

Ananth Madhavan of BlackRock noted that bond ETFs act as tools for price discovery—in March, they traded at tighter spreads than the underlying bonds. Many of these ETFs, however, also traded at a discount to their stated, end-of-day NAV. He believes that utilizing intraday pricing is important to show investors intrinsic value.

Derek Hafer of Citi stated that Citi uses third-party data services to verify its own internal pricing. During the March and April volatility, dealers were providing fewer quotes for on-the-run instruments, which also made it difficult to provide pricing for off-the-run bonds as well.

Sonali Theisen of Bank of America stated that bond-by-bond pricing information from a third-party service can't necessarily be relied upon when trying to determine pricing for a portfolio of many instruments. She believes that robust and consistent best practices should exist for how these services operate, as well as investor education on such pricing services generally.

One committee member asked whether the prevalence of odd-lot data has impacted the market. Heckert said that trade size used to be important and could differentiate categories of participants. He also noted that more buy-side participants are trading smaller sizes, such that information about liquidity in smaller notional sizes is more relevant.

One committee member asked whether bond fund redemptions should be limited when great pricing deviations exist. Madhavan believes that that redemption restrictions are a bad idea because a suspension on subscriptions or redemptions creates concerns about liquidity.

Panel Discussion on Transparency in the Market for Large Size Trades

The FIMSAC moderated a follow-up panel discussion on post-trade transparency for block trades in corporate bonds, focusing on the comments to FINRA's 2019 proposed pilot program. The pilot would increase the current dissemination caps for corporate bond trades and delay dissemination of any information about trades above those caps for 48 hours; it would also include a control group. Further, the pilot would decrease the time for which uncapped data would be later revealed to 3 months (from 6 months).

FINRA provided a summary of the 31 comments that it received.[6] Of those comments, 25 opposed the dissemination delay, including 11 buy-side firms or groups. However, 5 comments supported the delay, including 3 buy-side firms. Notably, 14 comments stated that a pilot is not needed because insufficient evidence exists of a market problem or because existing data should be further studied before proposing changes to dissemination.

Kumar Venkataraman of SMU believes that the FINRA pilot program isn't necessary. He noted the benefits of TRACE reporting for bonds, including a reduction in institutional trading costs. He also described his perceived unintended effects of the FINRA pilot, which includes higher trading costs for retail investors, large institutional investors that split their orders, smaller market participants, and non-traditional liquidity providers on electronic platforms.

Sonali Theisen of Bank of America also does not support the FINRA pilot program due to the proposed use of a randomized control group. She believes that a randomized group is too complex and costly, and therefore, unlikely to yield meaningful results. Theisen also noted that if a natural need to trade large size exists, then traders likely would break a large trade into smaller trades. However, she would be interested in studying whether this approach is more efficient.

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endnotes

[1] An archived webcast of the meeting is available on the SEC's website at https://www.sec.gov/video/webcast-archive-player.shtml?document_id=fimsac060120. A list of committee members is also available on the SEC's website at https://www.sec.gov/spotlight/fixed-income-advisory-committee.

[2]

https://www.sec.gov/spotlight/fixed-income-advisory-committee/preliminary-recommendation-re17a-7.pdf.

[3] Other safeguards could include different post-trade oversight, board of director oversight mechanisms, and policies and procedures that address the selection and use of an independent price source.

[4] https://www.sec.gov/spotlight/fixed-income-advisory-committee/fimsac-recommendations-pre-trade-transparency.pdf.

[5] https://www.sec.gov/spotlight/fixed-income-advisory-committee/fimsac-recommendations-credit-ratings-subcommittee.pdf.

[6] https://www.sec.gov/spotlight/fixed-income-advisory-committee/finra-block-pilot-comment-summary.pdf.
