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FINRA Requests Comment on a Proposed Pilot Program to Study Changes to Corporate Bond Dissemination Rules

[31727]

April 23, 2019 TO: Equity Markets Advisory Committee
ETF (Exchange-Traded Funds) Committee
Fixed-Income Advisory Committee RE: FINRA Requests Comment on a Proposed Pilot Program to Study Changes to Corporate Bond Dissemination Rules

The Financial Industry Regulatory Authority (FINRA) recently requested comment on a proposed pilot program to study changes to corporate bond block trade dissemination rules based on recommendations of the Securities and Exchange Commission's (SEC) Fixed Income Market Structure Advisory Committee (FIMSAC).[1] Specifically, the proposed pilot would study two primary changes recommended by the FIMSAC: an increase to the current dissemination caps for corporate bond trades, and delayed dissemination of any information about trades above the proposed dissemination caps for 48 hours.

Comments on the proposed pilot are due by June 11, 2019.[2] If you would like to share your views on the Proposal, please contact Sarah Bessin (sarah.bessin@ici.org) and George Gilbert (george.gilbert@ici.org) by May 2, 2019.

Background on Corporate Bond Trade Dissemination

FINRA's Trade Reporting and Compliance Engine (TRACE) provides information to investors and other market participants about secondary market trades in corporate bonds. Today, all OTC secondary market trades in TRACE-eligible corporate bonds must be reported to FINRA as soon as practicable, but no later than within 15 minutes of the time of execution. FINRA publicly disseminates information about these trades immediately upon receipt.

FINRA applies dissemination caps to trades that exceed $5 million for investment grade (IG) corporate bonds, and $1 million for non-IG corporate bonds. For trades at or below the caps, FINRA disseminates the security identifier, whether the trade was between dealers, or between a dealer and a customer or affiliate, whether the FINRA member involved in the trade bought or sold the security, and the price and full size of the trade. For trades above the dissemination caps, FINRA disseminates all of the same information, but with the size of the trade capped as "5MM+" (for IG) and "1MM+" (for non-IG). The full, uncapped size of trades above the caps is later published as part of an historical dataset six months after the

calendar quarter in which they are reported.[3]

FIMSAC Recommendation for a Block Pilot

The SEC empaneled the FIMSAC in 2017 "to provide the Commission with diverse perspectives on the structure and operations of the U.S. fixed income markets, as well as advice and recommendations on matters related to fixed income market structure."[4] FIMSAC considered the state of bond market liquidity at its first meeting. The discussion identified, among other things, the perceived dealer cost of TRACE's immediate post-trade transparency as an area to study.

Further to this discussion, the FIMSAC introduced at its second meeting a recommendation for a pilot program to study specific changes to FINRA's post-trade transparency protocols for block-size trades in corporate bonds.[5] The FIMSAC recommendation includes two primary elements. First, it would increase the current dissemination caps from $5 million to $10 million for IG corporate bonds, and from $1 million to $5 million for non-IG corporate bonds. This would result in the dissemination of additional size information for trades between the current and proposed caps. Second, the recommendation would delay dissemination of any information about trades above the proposed $10 and $5 million caps for at least 48 hours. This would result in no price or size transparency for these trades during the dissemination delay period. After 48 hours, the trade price and capped size of the trade would be disseminated and the full size of the capped trade would be published three months after the calendar quarter in which the capped trade was reported to FINRA, rather than the current six-month delay.

Summary of the Proposed Pilot Program

FINRA's proposed pilot incorporates the two primary elements of the FIMSAC recommendation. It also includes elements designed to produce pilot data that can be measured against a baseline, to facilitate evaluation of how the pilot affects market integrity and investor protection, including large investors that trade in block sizes, smaller investors that do not, and investors in derivative or other related markets.[6] The Proposal also includes an assessment of the potential economic impacts of the pilot.[7]

The Proposal also asks more than 50 specific questions about the proposed pilot, which are set out in appendices to this memorandum. Appendix 1 includes questions about the criteria that FINRA plans to use to evaluate the impact of the Proposal. Appendix 2 includes other types of questions.

The following chart summarizes the proposed pilot design:

Proposed FINRA Pilot Program on Corporate Bond Block Trade Dissemination

Duration

One year, but subject to early termination if market quality indicators demonstrate a significant disruption.

Included Bonds

Non-convertible, callable and non-callable TRACE-eligible corporate debt securities, except for bonds issued by religious organizations or for religious purposes (*e.g.*, church bonds),

and equity-linked notes

Treatment of New Issues

Included in the pilot the first day after they begin trading in the secondary market

Pilot Groups

Control Group

Current dissemination rules apply. Dissemination caps set at $5 million for IG corporate bond trades and $1 million for non-IG corporate bond trades. No dissemination delay for trades above the capped sizes.

Test Group 1

No change to dissemination caps. 48-hour dissemination delay for trades above the capped sizes.

Test Group 2

Dissemination caps increased to $10 million for IG corporate bond trades and $5 million for non-IG corporate bond trades. No dissemination delay for trades above the capped sizes.

Test Group 3

Dissemination caps increased to $10 million for IG corporate bond trades and $5 million for non-IG corporate bond trades. 48-hour dissemination delay for trades above the capped sizes.

Rotation

Control Group bonds will rotate into a Test Group and Test Group bonds will rotate into the Control Group halfway through the pilot.

Method for Creating Pilot Groups and Rotating Bonds During the Pilot

FINRA proposes to implement stratified sampling for this pilot in a manner that permits comparison between each test group and the control group. Pilot bonds would be stratified along the characteristics of bond issue size, age of bond issue, bond rating and 144A status. FINRA would use these variables to create categories, or buckets, of bonds. Bonds in each of the buckets would be randomly assigned before the start of the pilot to the four pilot groups (three test and one control), with Test Groups 1, 2 and 3 each containing one-third of the bonds randomized to the control group.[8]

FINRA further proposes to rotate pilot bonds halfway through the pilot. After approximately 6 months, bonds that are initially randomized to one of the test groups would be rotated to the control group, and the bonds initially in the control group would be divided equally into the three test groups. The sole exceptions to the rotation approach would be bonds that are newly issued close to the rotation date, or bonds that default during the pilot. New issues that trade fewer than 50 total trading days before rotation occurs would not be moved from the test or control group to which they were initially randomized, and bonds that default would not be moved from the test or control group to which they were initially randomized.

Rotation of the bonds between test and control groups is intended to address concerns that test and control assignment could impose unfair costs and burdens.[9]

Proposed Criteria for Assessing Pilot Impact

FINRA proposes to use a "difference-in-difference" method to evaluate how the pilot affects corporate bond markets. FINRA explains that this method is generally accepted as an effective way to assess changes in transparency for corporate bonds and it permits a comparison of the pilot's findings to earlier studies.[10] FINRA intends to consider the following metrics to evaluate the impacts of the proposed pilot: (1) trading activity; (2) block trading activity; (3) trading costs; (4) dealer behavior; (5) dealer compensation; (6) buy-side behavior; and (7) effects on other products, specifically exchange-traded funds, mutual funds, and derivatives. Appendix 1 includes a list of questions that FINRA has asked about how to evaluate pilot data.

Appendix 1: Questions Concerning the Proposed Criteria for Assessing Pilot Impact

FINRA solicits comment on whether the proposed pilot can provide answers to the following questions (organized by type of measure) and, if so, how these questions would be measured empirically:

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; or
   4. decrease uncertainty/error in prices?

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; or
   3. increase the time between block trades?

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); or
   2. decrease costs from adverse selection (*i.e.*, price impact)?

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; or
3. increase the probability of gaming by dealers, for example, altering their trading pattern to selectively release prices or make information more asymmetric?

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; or
   4. increase profitability of larger dealers at center of the dealer network?

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?

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?

Appendix 2: Other Requests for Comment

FINRA requested comment regarding the following specific questions:

Comments on the Need for the Pilot

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

2. Is the objective of the pilot clearly defined?

Comments on the Potential Impact of the Pilot

1. What potential impacts of the pilot does this proposal fail to consider or inadequately describe?

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

3. One suggested need for the pilot is that block size transactions have become substantially more difficult to execute and may result in breaking the block into smaller transactions. To the extent blocks have in fact become more difficult to trade, is this a valid concern? Do potential delays in block size trades and related strategies to execute those block trades, such as more smaller-size trades, lead to a more accurate and appropriate risk transfer? Would delays in dissemination improperly mask the risk of block-size trades to the individual firm and instead shift such risk to other market participants or the overall market?

4. FINRA cannot directly measure the impact on “lost opportunities,” particularly to asset managers. How would this negatively impact the success of the pilot? What other measure or data sets should FINRA consider in order to measure “lost opportunities” to trade?

5. Are there ways market participants can alter their behavior during the course of the pilot to affect its outcome? What are other similar negative impacts or concerns that could occur as a result of the pilot? What changes can FINRA make to the pilot design to limit or mitigate the impact of such “gaming”?

Comments on Pilot Design

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

2. Are Test Groups 1, 2 and 3 and the control group clearly defined?

3. What should the test groups be?

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

5. Should other types of securities, aside from corporate bonds, be included in the pilot?

6. Should the corporate bond CUSIPs in Test Groups 1, 2 and 3 switch with those in the control group with respect to the three treatments, which are the dissemination delay, dissemination cap, dissemination cap and delay?

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

8. Should the pilot include a control group?

9. Should the test groups be designed such that the impact is limited to the thresholds identified in the FIMSAC Recommendation? Is it appropriate to expand the test in the way proposed in the pilot design here?

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

11. Is the proposed methodology of examining pilot data appropriate?

12. Are the dimensions on which the corporate bonds are sorted (size of issue, age of issue, rating and 144A versus non-144A categories) appropriate? If not, which additional dimensions should be included (*e.g.* inclusion status with respect to an index or ETF, maturity, standardized versus complex, degree of substitutability for other CUSIPs, mean frequency of trading in prior year, etc.)?

13. 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)?

14. How should FINRA seek to measure the impact of the pilot on assets that derive their value from corporate bonds, such as ETFs and mutual funds?

15. Should the pilot's duration be increased to two years to better incorporate trading in illiquid corporate bonds?

16. 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)?

17. Are there additional research questions that should be addressed?

18. Are there other changes to the pilot that should be considered to better study the impact of dissemination (*i.e.*, transparency) on the corporate bond market?

19. Should the dissemination delay or caps only apply to trades on which a broker-dealer makes a capital commitment?

20. 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?

21. Should new issues be randomized to test groups or the control group while controlling for the issuer?

Comments on the Economic Impact Assessment

1. Does the economic baseline accurately describe current trading of TRACE-reportable corporate bonds?

2. What will be the overall impact of the pilot on liquidity, trade size, competition among dealers or competition among issuers?

3. 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?

4. 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?

5. With respect to the increase of the reporting cap size and the 48-hour dissemination delay (*i.e.*, Test Group 3), have its benefits and costs relative to Test Group 1 or 2 been adequately described?

6. The comparison of Test Group 3 and Test Group 1 is confounded by the increase in the threshold for the dissemination delay. Should FINRA consider the alternative construction for Test Group 1 discussed above, where Test Group 1 would maintain the current size dissemination cap while implementing a delay threshold consistent with the threshold in Test Group 3? Would such an alternative construction for Test Group 1 provide a cleaner test of the impact of the dissemination delay? Would such an alternative construction for Test Group 1 create complications that affect the implementation of the pilot?

7. What impact would the dissemination delay or cap have on broker-dealer routing to or trades occurring on alternative trading systems or on electronic trading innovations? Are these impacts different from those experienced by those transacting OTC?

8. Will the dissemination delay or cap create opportunities for market manipulation, and if so, what specific behaviors should either be measured or guarded against?

9. The current assignment of CUSIPs to Test and control groups does not control for the issuer’s identity. If CUSIPs are not normally distributed by issuer across control and a particular Test Group or across Test Groups, will there be difficulty interpreting the empirical results? If so, how?

10. Would assignment of an issuer to a particular Test Group change competition between issuers? If so, how?

11. What will the impact on competition be between issuers when some issuers' bonds are in the Test Groups versus the control group?

12. Will the dissemination delay or cap have an impact on competition among dealers? Are dealers who trade larger blocks sizes likely to benefit at the expense of dealers who do not make such trades? If so, how will the dealer network be affected?

13. Will the dissemination delay discourage institutional investors who do not trade larger block sizes from trading with those dealers who do trade larger block sizes? Alternatively, will the dissemination delay encourage institutional investors who do trade larger block sizes to selectively trade with those dealers who do not trade larger block sizes?

Comments on Alternatives to Consider

1. 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?

2. Should FINRA consider an alternate reporting design for the dissemination delay test group whereby brokers could report capped trades up to 48 hours after transaction and FINRA would disseminate the trade report when received? Under what conditions would brokers report capped trades earlier than the maximum delay permitted under the pilot? What are the costs and benefits associated with this approach?

3. Should FINRA consider an alternate design that would study, in place of delayed dissemination, suppression of the buy/sell indicator for block-size trades in corporate bonds? As noted above, FINRA currently disseminates this indicator, among other information, for corporate bond trades. However, for trades in Asset-Backed Securities (ABS), FINRA suppresses the buy/sell indicator (and information about contra party type) to balance concerns about transparency and liquidity in the ABS market, which is generally smaller and more institutional than the corporate bond market. What are the costs and benefits associated with an alternative approach that would study ABS-like dissemination protocols for block-size trades in corporate bonds?

4. Can the goals of the pilot be achieved through other means, such as study of currently available data or supplemented with other specific data requests?

5. As discussed above, certain baseline data suggests that block-size trades in IG bonds have not become more difficult to execute. Does the current data support an alternative approach that would limit the study of delayed dissemination to non-IG bonds? What are the costs and benefits associated with such an alternative approach?

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endnotes

[1] *See* FINRA Regulatory Notice 19-12 (April 12, 2019), *available at* https://www.finra.org/industry/notices/19-12 (Proposal).

[2] FINRA will need to file the proposed rule change with the SEC pursuant to Section 19(b) of the Securities Exchange Act of 1934 before the pilot can take effect.

[3] *See* Proposal at 4.

[4] *See* Securities Exchange Act Release No. 81958 (October 28, 2017), 82 FR 50460 (October 31, 2017).

[5] *See* Recommendation for a Pilot Program to Study the Market Implications of Changing the Reporting Regime for Block-Size Trades in Corporate Bonds (April 9, 2018), *available at* https://www.sec.gov/spotlight/fixed-income-advisory-committee/fimsac-block-trade-recommendation.pdf.

[6] *See* Proposal at 11.

[7] *See id.* at 26-30

[8] FINRA describes the rationale for using bond issue size, age of bond issue, bond rating and 144A status to create its stratified pilot groups at pages 12-13 of the Proposal.

[9] *See id.* at 14.

[10] For a description of how the difference-in-difference method would work in the context of the proposed pilot, *see* pages 14-15 of the Proposal.
