

COMMENT LETTER

November 12, 2012

ICI Comment Letter on FINRA Notice Regarding TRACE Reporting (pdf)

November 12, 2012 Marcia E. Asquith Office of the Corporate Secretary FINRA 1735 K Street, NW Washington, DC 20006-1506 Re: FINRA Request for Comment on Trade Reporting and Compliance Engine ("TRACE") (Regulatory Notice 12-39) Dear Ms. Asquith: The Investment Company Institute¹ is pleased to respond to the Financial Industry Regulatory Authority's ("FINRA") request for comment on issues related to the dissemination of information on securities transactions eligible for reporting on the Trade Reporting and Compliance Engine ("TRACE").² Registered investment companies ("funds") are significant investors in the fixed-income markets.³ As such, funds and their shareholders benefit from fixed-income markets characterized by transparency and liquidity. Our letter reflects the views of a majority of ICI members as to the effect that the contemplated changes to the TRACE system will have on the functioning of the fixed-income markets at this time. These views are not representative of all ICI members, some of which take opposing views. FINRA currently requires its members to report to TRACE all secondary transactions in certain fixed-income securities within fifteen minutes of the time of execution.⁴

The transaction 1 The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$13.8 trillion and serve over 90 million shareholders. 2 Regulatory Notice 12-39 (September 2012) ("Notice"), which is available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p163711.pdf>. 3 At year-end 2011, investment companies held 15 percent of the total of United States and international corporate bonds. See 2012 Investment Company Fact Book, A Review of Trends and Activity in the U.S. Investment Company Industry, Investment Company Institute, at p. 12, which is available at www.icifactbook.org. 4 See FINRA Rule 6730. Ms. Marcia Asquith November 12, 2012 Page 2 of 4 information for investment grade corporate debt securities and agency debt securities disseminated from TRACE includes the exact par value on all transactions with a par value of \$5 million ("5M") or less and includes an indicator of "5MM+" in place of the exact par value on transactions where the par value is greater than \$5M.5 With respect to non-investment grade TRACE-eligible securities, the exact par value on all transactions with a par value of \$1 million ("1M") or less is disseminated and any transaction in excess of \$1M is disseminated as "1MM+." (The \$1M and \$5M thresholds are referred to collectively in this letter as "dissemination caps.") TRACE was first established to increase transparency in the corporate debt market and dissemination caps were intended to respond to industry concerns about the potential

negative impact that immediate dissemination of transaction data could have on liquidity.⁶ The Notice explains that as part of FINRA's periodic evaluation of current practices, it is seeking input on whether to modify, leave unchanged, or eliminate the \$5M investment grade and \$1M non-investment grade dissemination caps for corporate debt securities. The Notice also seeks comment on whether to modify the \$5M dissemination cap for agency debt securities and whether information regarding Rule 144A transactions should be disseminated in the same manner as publicly traded corporate debt securities. Corporate Debt Transactions. The current \$1M and \$5M dissemination caps are considered round lot transaction amounts, and we believe, at this time, that these thresholds provide adequate transparency regarding transaction prices in the corporate debt market. At the same time, we are concerned that increasing or eliminating the current dissemination caps will negatively affect liquidity for corporate debt securities. Secondary market liquidity for investors in the fixed-income market, such as funds, is provided by dealers that are willing to risk their capital pending the location of customers who are willing to purchase a block of bonds. Revealing the exact par value of large trades (especially for certain infrequently traded issues) would allow other dealers to identify the dealer, including information about a dealer's inventory and investors involved in the trade. This information could then be used to trade against the dealer's position and reduce the incentive for a dealer to take large positions in these circumstances. This in turn could have unintended consequences for all market participants (retail and institutional) by impairing liquidity (e.g., caused by the unwillingness of dealers to continue their active role in the fixed-income market). We are particularly wary of modifying dissemination of TRACE information in ways that might negatively affect liquidity at this time given that liquidity in the corporate bond markets has declined since the financial crisis in 2008, and other pending regulatory changes have potentially negative, as yet unknown, implications for liquidity in the fixed-income market. In particular, we are concerned that the proposed rule to implement Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, commonly known as the Volcker Rule, could restrict banks from playing their 5 Disseminated TRACE transaction data includes, among other information, price, time of execution, and size. ⁶ See SEC Release No. 34-42201 (December 3, 1999), which is available at <http://www.sec.gov/rules/sro/nd9965n.htm>. Ms. Marcia Asquith November 12, 2012 Page 3 of 4 historic role as market makers buying and selling securities. If banks could not provide these services, particularly in the less liquid fixed income market, funds likely would face wider bid-ask spreads, higher transaction costs and diminished returns. ⁷ Similarly, the federal banking agencies have issued proposed rules that would substantially revise the capital framework for U.S. banking organizations. The proposals would, for example, remove the Accumulated Other Comprehensive Income ("AOCI") filter from existing bank regulatory capital rules, which would result in short-term gains and losses on available-for-sale securities portfolios "flowing through" to banking organizations' regulatory capital, thereby increasing capital volatility. In response, banking organizations may reduce their holdings of fixed-income securities, which would decrease overall market liquidity.⁸ We therefore recommend that FINRA retain the current dissemination caps. We would not object, however, to FINRA again seeking comment on modifying the dissemination caps after the market implications of the regulatory changes discussed above are fully understood by market participants. Agency Debt Transactions. The Notice seeks comment on whether to modify the \$5M dissemination cap for agency debt securities. In response to the financial crisis, significant changes have occurred in the agency debt market that have resulted in diminished liquidity. For example, the Federal National Mortgage Association and Federal Home Loan Mortgage Corporation each have been required to reduce the size of its portfolio of mortgage loans. Reducing their debt outstanding has led to diminished liquidity in the market for agency debt securities. To avoid further reducing the liquidity in

that market, we recommend leaving unchanged at this time the current dissemination cap of \$5M for agency debt securities. As with corporate debt transactions, we would not object to FINRA again seeking comment on modifying the dissemination cap for agency debt securities after some period of time has passed to allow market participants to better understand the long-term implications of the recent changes in the market. Rule 144A Transactions. Unlike transactions in publicly traded debt securities, Rule 144A transaction information currently is not disseminated.⁹ Therefore, under the current approach, there is limited or no price transparency for Rule 144A transactions. The Notice seeks comment on whether 7 For a more detailed explanation of our concerns, see Letter from Paul Schott Stevens, President & CEO, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission; Robert E. Feldman, Executive Secretary, Federal Deposit Insurance Corporation; Jennifer M. Johnson, Secretary, Board of Governors of the Federal Reserve; John G. Walsh, Acting Comptroller of the Currency, Office of the Comptroller of the Currency; and David A. Stawick, Secretary, Commodity Futures Trading Commission, dated February 13, 2012, which is available at <http://www.ici.org/pdf/25909.pdf>. 8 See Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action, 77 Fed. Reg. 52,792 (Aug. 30, 2012); Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements, 77 Fed. Reg. 52,888 (Aug. 30, 2012); and Regulatory Capital Rules: Advanced Approaches Risk-Based Capital Rule, Market Risk Capital Rule, 77 Fed. Reg. 52,978 (Aug. 30, 2012). 9 See FINRA Rule 6750(b)(1). Ms. Marcia Asquith November 12, 2012 Page 4 of 4 information regarding Rule 144A transactions should be disseminated in the same manner as transactions in publicly traded corporate debt securities. Funds are qualified institutional buyers that participate in the Rule 144A market. As with the publicly traded bond market, funds and their shareholders benefit from being able to participate in a Rule 144A market that is sufficiently transparent and liquid. The Rule 144A market has, over time, become a more mature and liquid market with no corresponding enhancement in its transparency. We therefore recommend that information regarding Rule 144A transactions be disseminated to the same extent as comparable non-Rule 144A transactions.¹⁰ * * * * We look forward to working with FINRA as it continues to examine this issue. In the meantime, if you have any questions, please feel free to contact me at (202) 218-3563. Sincerely, /s/ Dorothy Donohue Dorothy Donohue Deputy General Counsel—Securities Regulation cc: Sharon Zackula, Associate Vice President and Associate General Counsel Office of General Counsel FINRA 10 In particular, we recommend that the transaction information for investment grade corporate debt securities and agency debt securities sold in Rule 144A transactions disseminated from TRACE include the exact par value on all transactions with a par value of \$5M or less and include an indicator of “5MM+” in place of the exact par value on transactions where the par value is greater than \$5M. With respect to non-investment grade corporate debt securities sold in Rule 144A transactions, we recommend that the exact par value on all transactions with a par value of \$1M or less be disseminated and an indicator of “1MM+” be used to describe any transaction in excess of \$1M.