BondCliQ

The Inside Market June 2019

As a new solution provider, we intend to make your assessment process easier by clearly and consistently articulating our approach to improving the US corporate bond market through our monthly blog post (The Inside Market). This post will touch on just a few topics, but there will be many more to come. To be clear, **this forum WILL NOT be used to talk in detail about the BondCliQ product**. We have a nice website for that, thank you (www.bondcliq.com). Your feedback, criticisms, thoughts, and, of course, encouragement are welcome. Feel free to comment openly or directly to me (chris@bondcliq.com).

The Comment Section

Earlier this month, FINRA called for comment letters on the current proposal to delay TRACE reporting for large corporate bond trades. If you are an avid fan of market structure debates and really into bond market data, the 20 plus comment letters make for very entertaining reading. However, for some, reading every individual comment letter might be slightly less captivating. No worries, our blog post this month is dedicated to highlighting the key points that question the logic of removing key information from the corporate bond market. Before we begin, we'd like to acknowledge one submission in particular, Descartes Trading:

We are concerned by the 48h delay for trades above a certain size.

According page 6 of your notice paper, for **non-IG, it might imply that 40.8% of total volume traded will delayed by 48h.. It is a lot.**

It would clearly give a substantial advantage to large players . As we are a small player, we will feel at a disadvantage and worried trading US non-IG.

Kind regards.

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Boss move Henri. Respect!

Make the Markets Great Again!

The catalyst for the suggested TRACE delay is the undeniable fact that US corporate bond markets have experienced a prolonged period of illiquidity. This problem could manifest into a material issue if meaningful volatility were to return to the market. Just last week, IOSCO published "Liquidity in Corporate Bond Markets Under Stressed Conditions" which is a 52-page ghost story on what could happen to trading conditions when rates normalize. To prevent massive dislocations due to illiquidity, some believe that removing transaction data from the market will…enhance liquidity? Regardless of your view on this idea, it is important to acknowledge the obvious link between TRACE and market innovation. The current US corporate bond market is unrecognizable from the pre-TRACE days almost 20 years ago. Since the introduction of centralized transaction data, we've seen the rapid growth and adoption of electronic trading, new products (ETFs, CDS, and CDX) and market data solutions. It is hard to imagine these evolutionary milestones occurring without the foundation of TRACE information in place. Rolling back the reporting requirements could slow down the pace of innovation at a time when the market desperately needs new ideas to be great again.

Vanguard emphasizes this point very early on in their comment letter:

"Restricting market participants from acquiring current transaction information ***will also hinder the evolution and electronification of the corporate bond market*****.** ***Post-trade transparency serves as a foundational building block to foster technological changes and innovation in the fixed income markets.*** *Information obtained through post-trade transparency will increasingly facilitate liquidity as fixed income markets evolve from principal-based market making to agency and electronic market structures."*

The Price Is?

Every day the institutional bond market participants must assign a value to individual positions with notional sizes in the millions. This process is a requirement for actively managed portfolios, passively managed index products (ETFs) and inventory held by dealers. Accuracy of portfolio valuations and risk analytics depends on complete information about prices and transactions.

Healty Markets Association did an excellent job of articulating this point in their comment letter and includes supporting comments from FINRA for good measure:

"Loss of Price References for Market Participants.

Most market participants would lose an incredibly valuable reference point--not just for the security traded, but for similarly situated securities. This could impact evaluative pricing tools, such as those offered by third parties, and relied upon by many market participants – not just in the pricing those specific bonds but other bonds where those prices are used in evaluating fair values**.** *Put simply, all investors other than the dealer involved in the trade would not be aware of the important reference point. This could lead to executions for retail and other institutional investors at materially worse prices. Further, this loss of a reference price may materially impact a number of other financial products, such as bond-based ETFs.*

As the FINRA Proposal notes:

The impact of delayed reporting may well have an amplified effect on securities deriving their value from corporate bonds. The impact could lead to less efficient pricing of index-based products, such as ETFs, and derivatives, such as total return and credit default swaps. If the pilot makes it more difficult to mark-to-market the relevant securities, market participants, who do not trade blocks benefitting from delayed reporting dissemination, may be more likely to use stale prices for operational and accounting purposes.

We agree with this significant concern. The data reflects that as much as 50.5% of those block trades occur in bonds that are included in at least one of the seven largest fixed income ETFs. This is a significant concern for investors and market makers in those ETFs."

Just the Facts Ma'am

Pushing a pilot program for testing a theory on market structure is no small feat. It requires the formation of a problem. The suggestion of an idea to solve said problem. Then, most importantly, evidence that supports the theory behind the suggested solution. If you've been paying attention to the FIMSAC discussions regarding the TRACE delay, a key argument against the pilot has been the lack of evidence that removing transaction data would help trading conditions.

Citadel smashes this point home like an overhead lob:

*"...**to the extent there has been any deterioration in block trade liquidity, there is no evidence to suggest that it is due to the current post-trade transparency framework**. In contrast, academic research has found that post-trade transparency has improved corporate bond liquidity and has reduced transaction costs. Post-trade transparency has benefited not only retail investors, but also institutional investors transacting in larger size**. In particular, academic research has found that post-trade transparency has caused "trading costs to decline significantly for the entire bond market" and has even improved liquidity conditions for block trades, directly contradicting the claims made by those supporting the Proposed Pilot**. Specifically, an analysis of the institutional 144A corporate bond market found that the introduction of post-trade transparency in 2014 significantly reduced transaction costs for block trades, with the largest reductions observed for blocks that exceed $25 million in size. In addition, **there was no evidence that post-trade transparency reduced block trading volume or otherwise impeded the ability of market participants to execute blocks, or reduced dealers' willingness to hold inventory. In fact, overall trading volume of large blocks increased following the introduction of post-trade transparency**. FIMSAC did not appear to consider the academic research above as part of its deliberations. Moreover, FIMSAC did not explain why it narrowly focused on suggesting changes to the post-trade transparency framework, as opposed to considering other aspects of market structure that can impact liquidity conditions, such as regulatory capital requirements, the ongoing transition to electronic trading, the observed increase in agency/riskless principal trading, and liquidity dynamics in hedging instruments, such as single-name credit default swaps. Ultimately, neither FIMSAC nor FINRA were able to identify any academic research supporting the suggestion that reducing post-trade transparency can be expected to improve liquidity conditions for block trades. As a result, **the asserted benefits of the Proposed Pilot appear to be unsubstantiated and illusory**."*

Trust Me

When designing a trading platform, a virtual market place or even a board game, the rules and protocols cannot be susceptible to manipulation. Any product development person will tell you that a critical part of their process is thinking about behaviors that could "game" the system and coming up with techniques to eliminate those activities. Failure to account for opportunism will ultimately cultivate opportunism, especially in situations where the stakes are high. There is a long history in financial markets of ideas that were intended to enhance market quality but ended up deteriorating market integrity (cough…SOES…cough…Bandits).

A two-tiered information dissemination structure creates countless scenarios for manipulation, but MIT Management provided a hypothetical, but plausible scenario in their letter:

"Delayed dissemination of trades may also lead to legal and systemic risks in times of stress and uncertainty. ***Suppose, hypothetically, an issuer faces imminent default, but only market participants close to the firm are informed of this likely event. The transaction prices between those sophisticated investors on the firm's bonds will reflect the imminent default risk. But if TRACE delays the dissemination of price information, smaller and less sophisticated investors may end up paying for the bonds at higher prices, which they would not pay if TRACE had reported the transaction prices in real time****. In this case, those small and less sophisticated investors are materially harmed by the delayed transaction reporting and may rightly resort to legal actions against FINRA. Worse still, if the defaulter in this hypothetical scenario is a systemically important financial institution, suppressing transaction prices of its bonds could even increase systemic risk."*

Need to Know Basis

We've written about transparency in a previous blog post (A Fear and Loathing of Transparency) and believe that transparency is a fundamental requirement for market innovation. However, to extract the benefits of transparency while avoiding the potential negative consequences, appropriate protocols around visibility and access are needed. With regards to TRACE information, a key question we have for FINRA and both sides of the current debate is this: **Why do size details need to be visible at all?** Replacing the size details with a standard indication of <$500k or >=$500k would address the concerns of those who believe transparency is hurting liquidity while maintaining equal access to critical transaction data.

For BondCliQ, we use a unique protocol approach to generate high-quality institutuional pricing data. Our system gives participating dealers access to essential pre-trade data while protecting their proprietary information. Maintaining this balance allows the data to get better over time and fosters an environment where transparency and innovation can lead to better liquidity conditions for all.

-Chris White (CEO – BondCliQ)