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Stand and Deliver – The Path to Executable Institutional Pricing in US Corporate Bonds

Judging the quality of corporate bond market data is a subjective process, especially when it comes to assessing the reliability of pricing information. Multiple factors like venue, time when the market was posted, size displayed, and the identity of the provider go into the equation that determines whether a price is dependable for trading. However, **the feature that seems to trump all other inputs is whether the price is "executable" which means it can be traded electronically "on screen."** In other markets, a live price is considered an "order," which means there is no last look afforded to the person who posts the market. Once someone tries to hit or lift the price, the trade is executed. **Many corporate bond platforms have tried to convert indicative prices into "order-driven" executable markets, but the same issue ultimately prevents this from happening: backing away.**

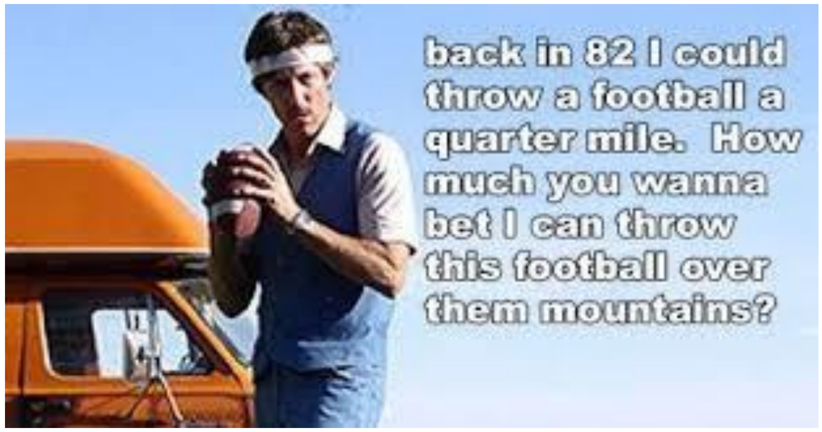
Backing away is when a price provider does not stand up to their market. This practice is in no way unique to electronic trading and happens all the time for both large and small transactions. If it wasn't for backing away, we wouldn't need lawyers when closing on a house and pinky swears would become a relic of the past. **For capital markets, when a price is posted electronically and appears to you on screen, there is a natural expectation that the market is real.** However, creating an environment where dealers will stand and deliver liquidity against their posted prices is not easy.

Bust a Deal and Face The Wheel

To many, breaking a deal, any deal requires serious consequences to deter others from repeating the same offense. In the early days of financial market systems, an individual's honor and reputation were the only collateral because there was little to no technology to enforce market integrity. This explains the old London Stock Exchange Motto: Dictum Meum Pactum – My Word is My Bond.

There is a growing assumption in the corporate bond market that technology and e-trading alone will ensure price integrity, but this has proven to be incorrect across multiple markets

Those Were the Days…



Nostalgia is a funny thing because it tends to distort the truth by presenting past events or eras as if they were much better or worse than reality. The stories of how it used to be are most often told to those who lack firsthand experience, so facts rarely get in the way of the storyteller's perspective. Recount a story enough times with enough distance between the past and the present, and the lines between someone's view and real history start to blur. This isn't a problem when people discuss something inconsequential like their old high school athletic career. However, when a nostalgic view of the past is treated as a guide for the future, mistakes can and will be made.

Those Who Do Not Learn History Are Doomed to Repeat It

Great quote, but when it comes to corporate bond market structure, many of today's ideas are designed to repeat the historical successes of other financial markets. For example, recent comments from a representative of a leading corporate bond electronic trading platform suggest that investors could "save billions" if participants started working executable orders for corporate bonds...like they've done in equities:

"The concept of working orders still hasn't reached the fixed-income market. I think there will be a lot of evolution around how clients can put some orders in the machine and work the larger, more complex orders. Innovations like that, or around how investors price bonds, are areas where the bond market can see big benefits from taking inspiration from how equities trade. Investors would save billions."

To translate a bit here, the concept of "working orders" in a market assumes that there is at least one well-functioning electronic order book to rest an order. In addition, putting some of those orders "in the machine" assumes that there are MULTIPLE well-functioning orders books, which would allow the

investor to realize the benefits of smart order routing. Now it is not a huge leap of faith to believe that an electronic order book could be built and launched for the corporate bond market. Multiple ECNs like Tradeweb Direct, TMC, MTS Bonds, UBS Bond Port and Knight Bondpoint have successfully established platforms that closely resemble order books with reliable markets for small sized (<$250k) trades. What this neat and tidy vision of corporate bond market evolution fails to acknowledge is that establishing price integrity on a broader scale is very difficult. We know this because back in the day, the US equity market struggled with the exact same issue of backing away. So while it sounds great to say that billions could be saved if we followed the path of equities, that path is long, difficult and not achieved by simply launching a platform with "live markets."

The Market That Time Forgot

I was recently reading a few old articles about market structure which is just a slightly more exciting hobby than stamp collecting. Every now and then I find content that can be best described as a time capsule because the market structure conditions and practices being discussed are all but forgotten. A great thing about historical content is that we know how the story ends so we view the information with full knowledge of the eventual outcome. The title of this excellent Los Angeles Times article from 1994 is very wordy and leaves very little to the imagination:

The Price of Backing Away: NASDAQ Market Makers Often Don't Honor the Prices They Display. Complaints Abound, But NASD Says Most Are Frivolous. This sounds oddly familiar to the current state of the US corporate bond market where execution quality can be suspect.

If you've assumed that the good old days of electronic trading in equities meant reliable prices, then there are a few startling statements in the 1994 Los Angeles Times article:

- *"Federal regulation--what's known as the "firm quote rule"--requires market makers to honor the prices they display."* Backing away was prevalent in a market that had a federal regulation prohibiting the practice.

- *"Through Oct. 4, traders had filed 4,748 complaints this year alleging Nasdaq market makers "backed away" from their obligation to trade at posted prices."* Almost 5,000 complaints had been filed YTD. Assuming that approximately 180 trading days had passed, there were an average of over 25 complaints of backing away every day. That may not sound like a lot, but this is only tracking violations that were formally reported. It is not hard to imagine the true daily average being a multiple of 25.

- "*While James M. Cangiano, the NASD's executive vice president for market surveillance, insists the group takes backing-away complaints "very, very seriously," the NASD confirms that it has taken no public action in response to any of the complaints filed this year."* There were no real consequences for backing away.

- *The trader offered to sell the shares to Morgan Stanley & Co., the giant Wall Street investment bank, which is also a major Nasdaq market maker. At that moment, Morgan Stanley had the best posted "bid" price for Intuit, offering to pay $49.25. Morgan declined to fill the order. But for at least 12 minutes after, the firm continued to post the $49.25 price, seemingly indicating that it was ready to take any legitimate offer at that price, as the firm-quote rule requires.* Rule breakers were bold and unafraid.

The Anatomy of Backing Away

It is very easy to place the blame of poor price integrity at the feet of the market maker. After all, they are the ones who posted the price in the first place, so it is they who must honor their market. This view assumes that backing away is caused by poor integrity alone which is missing the full picture. Yes, there are definitely market makers who post prices with no intentions of trading, but another major driver of backing away is protection. Not all people who take liquidity do so with the best intentions, so backing away functions as a safety valve. We see this directly in the LA Times article when the author provides details on who was making the complaints of backing away:

- *The NASD attributes the upsurge in backing-away complaints to a protest by a small group of market makers angry that the NASD cut into their living in January by sharply limiting Nasdaq's small-order execution system (known as SOES), which had been the basis for these firms' profits. The NASD says the firms abused SOES, unfairly using it to take advantage of big market makers who were not fast enough in updating their prices. Indeed, a prodigious 85% of the complaints through late June were filed by a single small firm that heavily used SOES, Datek Securities of Staten Island, N.Y., the NASD says.*

Not to get too nostalgic, but most if not all NASDAQ market makers considered Datek and other firms like them to be some very bad hombres. So bad in fact that they are better known as the "SOES Bandits" because of their consistent exploitation of NASDAQ's Small Order Execution System.

The US corporate bond market does not have SOES Bandits, but to believe that every liquidity taker has the best intentions when executing a trade is naïve. So let's step back for a moment and review what exactly is being asked of corporate bond market makers by vendors that want to create an order-driven institutional trading platform:

1) Provide live and executable prices on screen for material size
2) When someone engages you, complete the trade without knowing the counterparty
3) Never back away from the trade

While the dream of a live executable order book may be a lovely thought for some, the reality for a participating dealer is a nightmare where they are consistently negatively selected and unable to build meaningful bi-lateral relationships with the buy-side.

Making Institutional Markets Real

Anyone who believes that live institutional corporate bond markets are right around the corner is not considering the perspective of the sell side in their vision of market evolution. It will take years of incremental development in areas outside of electronic trading technology to foster an environment where dealers feel comfortable providing order-drive markets. **BondCliQ is building a system that has the key requirements for improving the quality and reliability of institutional prices.** Our platform allows dealers to see the same pricing information as buy-side institutions, so they always know the position of their market. We encourage bi-lateral, fully disclosed engagement between clients and dealers through attributed pricing with visible performance rankings. Finally, BondCliQ allows dealers to make their own decisions on engagement and does not force a market maker to trade electronically. With this approach, executable institutional markets can organically develop as a by-product of competition for high-quality customer order flow. -Chris White (CEO – BondCliQ)