BondCliQ

The Inside Market October 2020

The Covid-19 pandemic brought a tsunami of unexpected volatility to the global markets. While participants remained focused on adapting to the new normal, an undertow has formed around fixed income price transparency that could drag market participants into deep regulatory waters. Since May, several critical conversations on the future of fixed income market structure were held by AMAC. **If you just thought "AMAC?", I suggest you read on**.

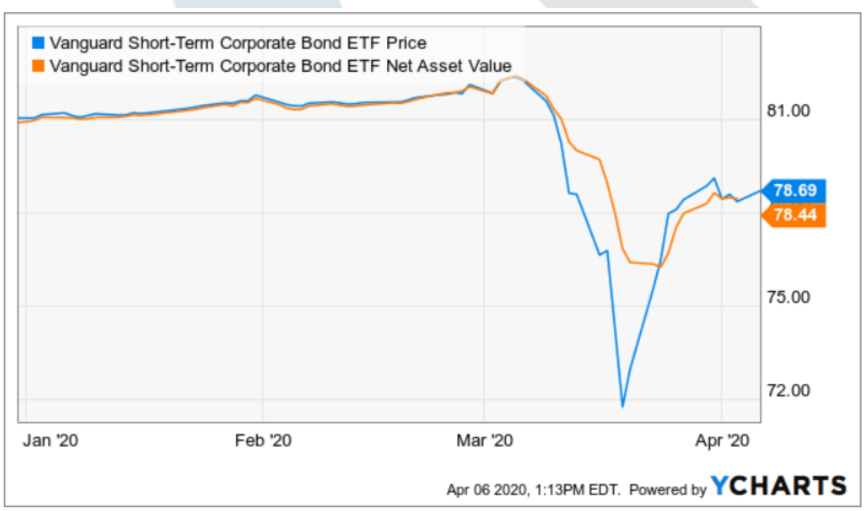
Setting the Table

The Asset Management Advisory Committee (AMAC) was formed to provide the Securities and Exchange Commission (SEC) with diverse perspectives on asset management and related advice and recommendations. A Covid-19 related topic that caught the eye of the trading community, media and subsequently the SEC, was the visible price discrepancies in corporate bond ETFs:

"There have recently been big discrepancies in the net asset values (NAVs) of bond ETFs and where they're actually trading. The NAV is determined by the total value of its assets minus the value of its liabilities. It's basically often used to help buyers and sellers determine a "fair price" at which a fund is trading. But **in the last few weeks, bond ETFs have been trading at sizeable discounts to the NAV**, like the iShares iBoxx $ Investment Grade Corporate Bond ETF (LQD)."

Bond Market Pricing 'Hasn't Recognized the New Reality.' Here's Why That's an Issue for Bond ETFs

CNBC March 26th, 2020



At one point, nearly half of taxable bond ETFs closed at a 1 percent or greater discount to NAV, with those ETFs accounting for around 60 percent of aggregate taxable bond ETF assets. In addition, about 5 percent of taxable bond ETFs closed at a 5 percent plus discount, though those ETFs represented only 3 percent of assets. In addition, about 5 percent of taxable bond ETFs closed at a 5 percent plus discount, though those ETFs represented only 3 percent of assets. Conversely, equity ETP NAV/exchange traded price correlations performed much better during this period of volatility.

When the AMAC convened on May 27th, particular attention was paid to the performance of Fixed Income Exchange Traded Products (ETP'S). In this meeting, committee members reasoned that "changes to fixed income market structure may reduce transaction costs and lessen the severity of premiums/discounts in fixed income ETPs during future periods of volatility" and focused on 4 potential areas in fixed income market structure that could enhance transparency and price discovery:

- Aggregating bids & offers through FINRA's Trade Reporting and Compliance Engine (TRACE);
- Evolving market standards to encourage more use of firms quotes;
- Disseminating a national best bid and offer; and
- Imposing tighter reporting and public dissemination requirements for bonds

These ideas were discussed throughout the summer and on September 16th, the SEC announced the formal AMAC recommendations on fixed income price transparency:

- The AMAC recommends that the SEC and FINRA analyze whether TRACE dissemination requirements should be calibrated to enhance transparency.
- The AMAC recommends that the SEC and FINRA analyze whether TRACE should be enhanced to include bid-offer information for corporate bonds and whether TRACE should disseminate bid offer information in real-time to market participants.
- The AMAC recommends that the SEC conduct a thorough review of fixed income market structure to assess whether other changes would encourage the evolution of market characteristics in the hopes of enhancing transparency, liquidity, and price discovery.

Reading the Tea Leaves

The first and third recommendations feature typical nebulous language connoting a lengthy exploratory process, but the second recommendation is a very concrete actionable item that can be considered and implemented in a "relatively" short period of time. This particular recommendation is also the essential foundation needed to enact the remaining two considerations of May 27; firm quotes and national best bid and offer. The outlined approach is a proven method to increase quote transparency, accuracy, and reliability in equity markets. Those improvements are good things for markets, right? What is not to like? Indeed, they are good things. However, the long-term market structure implications for corporate bonds in achieving this goodness are nothing short of titanic.

So what are these recommendations? Firm Quotes? This is fixed income, you ask five different participants what "firm quotes" mean and you'll get 5 different answers, all which sound plausible. Let's take a closer look at these ideas and examine the potential path and effects of their implementation.

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The aggregation of bid-offer information by a regulatory entity is traditionally the first step towards a path of market-wide dissemination. It may follow the TRACE trade reporting model, which features a FINRA charge to send the quote data, as well as consume the quote data. FINRA can potentially leverage the data for trade execution compliance, while dissemination in any form provides dealers with contextual information and customers an additional tool to analyze execution. The consumption and analysis of this new data will begin to bind aggregated quote information to the quality of trade execution. The evolution of this key principal progresses with..

“The AMAC recommends that the SEC and FINRA analyze … whether TRACE should disseminate bid offer information in real-time to market participants.”

The real time dissemination of quotes directly ties execution quality to the quoted context of the market. This likely attracts new high frequency traders to consistently be the best bid-offer on electronic venues because it makes their markets hard to ignore. Asset managers will feel compelled to engage these markets due to public best execution concerns. These new trading firms will leverage their technological prowess to consume the data and provide live executable quotes, which become prized over slower market makers who back away from stale quotes. If a quote is not live, it likely won’t be engaged. Remember the key consideration from the May 27th meeting? **“Evolving market standards to encourage more use of [firm quotes]”**. “A firm quote is non-negotiable, according to SEC Rule 11Ac1-1 — its firm quote rule. It is a take it or leave it offer. The market maker who published it is obliged to execute an order that is presented to it, at a price and size that is at least equal to its published firm quote.” Mission accomplished; firm quotes are the law of the land.

The establishment of firm quotes leads to the final consideration of the May 27th meeting; **Disseminating a national best bid and offer (NBBO).** This may lead to rules requiring that interest at the NBBO must be filled before executing the balance of the trade. This would require larger orders to be broken up.

The goal is accomplished. We have increased transparency, objectivity, accuracy, and reliability in fixed income markets. However, effectively engaging this new market structure will require a vast reconfiguration in the operations of existing participants.

It’s Alive!

The engineering required will touch every facet of buy and sell side trading. Participants should consider some of the key potential changes to the ecosystem needed to achieve the end goal.

Market Data

Making a firm quote with a best bid or offer will force market makers to constantly change prices and keep the sizes relatively small. The result is a massive growth of quote data. All market participants will need to pay for quote data, and the technology to consume, display, and leverage it. Those that want faster data feeds from trading venues will have to pay for the direct feeds.

Technology

Technology upgrades will be mandatory. For the buyside EMS functionality such as data aggregation, venue connectivity, order routing, and algorithms will be necessary. Sell side firms will need to upgrade market making technology in order to remain competitive.

Compliance

Compliance costs will increase as infrastructure around best execution and order handling will be needed.

Trading

Trades may need to be broken up to satisfy trading at the NBBO. The result will be an increase in execution costs, clearing costs, and information leakage. A myriad of new order protocols will arise as customers attempt to navigate the execution landscape. Anonymous trading will grow as new market makers avoid the cost infrastructure of bilateral client maintenance. The desire to avoid information leakage and to move large positions will create an industry around dark pools, direct connections, and IOI's as customers and dealers try to roll back the clock and trade in the dark.

The volatility wrought by the pandemic in the valuation of Fixed Income mutual funds and ETP's brought the lack of consolidated, objective, dynamic pricing to forefront of the SEC's market committees. The committee recommendations reveal that the market is considering a regulatory path towards a proven solution.

As market participants consider the potential consequences of this regulatory structure one thought may be, should they sharpen their consideration around a market-based solution?

Complex Systems Need Simple Solutions

As other modernized markets have shown, making basic transaction and pricing information available to all market participants is a fundamental requirement for innovation. **Due to the idiosyncratic nature of the institutional US corporate bond market, a standard approach to increasing transparency is sub-optimal**. We believe that leveraging the positive benefits of transparency is directly predicated on rules and protocols. **BondCliQ generates high-quality institutional pricing information by implementing unique protocols that improve access to data while appropriately socializing proprietary information and limiting the exposure of the dealer**. As more market participants use reliable pre-trade information to improve their trading decisions, risk management capabilities and market making performance, data will gradually be accepted as an invaluable commodity.

Quote transparency, accuracy, and reliability are at the forefront of investor and regulator concerns. Institutions should consider that thoughtful innovation can achieve these essential results while significantly mitigating the cost, regulation, and complexity of their implementation.

-Kevin Molloy (BondCliQ)