June 11, 2020

Mr. Christopher Kirkpatrick
Secretary, Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street NW
Washington, DC 20581

RE: CFTC Proposed Amendments to the Real-Time Public Reporting Requirement (RIN 3038-AE60)

Dear Mr. Kirkpatrick:

We appreciate the opportunity to provide comments to the Commodity Futures Trading Commission on the proposal ("the Proposal") to amend real-time public reporting requirements for swap block trades. The Proposal would permit a time delay for public reporting of block trades from 15 minutes (for most interest rate and credit derivatives) to 48 hours. Under the Proposal, over 30% of the notional value of trading activity qualifies as a block trade, indicating that a substantial portion of the swap market activity would be hidden from market participants for 48 hours. Adoption of the Proposal would result in a significant reduction in market transparency.

We strongly oppose delayed reporting of trade prices for large swap transactions. The Proposal will impose substantial costs on market participants who do not engage in block transactions and reduce the overall quality of data available in the market.

By way of background, we both are members of Securities and Exchange Commission's Fixed Income Market Structure Advisory Committee (FIMSAC) which explores the efficiency and resiliency of the fixed income markets and identifies opportunities for regulatory improvements. Larry Harris served as the Chief Economist of the Securities and Exchange Commission (2001-2004). Kumar Venkataraman served as a visiting academic scholar in the Office of Chief Economist at the Commodity Futures Trading Commission (2009-2011). We both have written extensively on a range of regulatory and market design issues in fixed income and equity markets. In particular, we both have previously studied the impact of the initiation of TRACE trade reporting on institutional and retail investors in the corporate bond market.[1]

FINRA's Pilot Proposal to Delay TRACE Large Trade Reporting

At its meeting on April 9, 2018, FIMSAC voted to advise the SEC to recommend that FINRA conduct a pilot study to understand better whether certain changes in how FINRA disseminates large corporate bond trade reports to the public would be beneficial. We dissented from the FIMSAC recommendation. Along with former SEC Chair Elisse Walter, we submitted a comment letter on the recommendation.[2]

[1] Larry Harris's resume is available: http://faculty.marshall.usc.edu/Larry-Harris/ and Kumar Venkataraman's resume is available: https://people.smu.edu/kumar/.
[2] https://www.sec.gov/comments/265-30/26530-4268151-173129.pdf

Current TRACE procedures provide for immediate dissemination by FINRA of corporate bond trade reports (which required entities must report immediately but in no case later than 15 minutes after the trade) that include the price of the trade and a measure of the size of the trade. For trades in investment-grade ("IG") bonds smaller than $5 million in par value, FINRA disseminates the full size of the trade. For larger trades, FINRA disseminates a note ("5MM+") that indicates that the trade size was $5 million or more. FINRA uses similar procedures for non-investment grade ("N-IG") bonds ("1MM+") except that the threshold is $1 million.

Following up on FIMSAC's recommendation, FINRA proposed a pilot program to study the impact of a 48-hour dissemination delay for large trades in corporate bonds.[3] Specifically, the FINRA pilot proposal will delay reporting of investment-grade (IG) bond trades larger than $10 million and non-investment grade (N-IG) bond trades larger than $5 million for 48 hours. All other trades will be reported immediately in full size. FINRA's pilot proposal thus decreases price transparency for trades above these thresholds and increases size transparency for IG trades between $5 million and $10 million and N-IG trades between $1 million and $5 million.

The proponents of the delayed reporting of block transactions in corporate bonds offered the following rationale for the change: The delayed reporting of large trades would give dealers more time to offset their positions so that they could offer more liquidity to large block sellers. Without this protection, dealers claim that their positions get front run. Although in principle, the argument applies both to large purchases and large sales, in practice, the rule primarily would affect only large purchases as dealers rarely make large sales that they must subsequently cover.

The Proposal asserts similar benefits as foundation for deferring public reporting of block swap transactions to 48 hours. We respectfully disagree with the asserted benefits of the Proposal. Below we identify the economic implications of the proposed change on information asymmetry and data quality. We also offer an alternative method for addressing the concerns of dealers who facilitate large block transactions.

Economic Implications of CFTC's Proposal

Before addressing the problems associated with delayed price reporting, we first note that we do not give much credence to the claim that timely publishing of large trade sizes causes dealers to lose significant sums to frontrunners. We do not believe that many traders sell ahead of dealers who are distributing blocks with the expectation of later repurchasing their bonds at lower prices. To do so requires that they either already own the bond or that they borrow the bond. The owners generally are reluctant to sell because they like what the own (which is why they own it), and short selling can be expensive. Moreover, in comparison to equity markets, all bond prices—especially IG bond prices—depend much more on general interest rate levels than on local supply and demand conditions for a given bond. Accordingly, the profits associated with front running are not likely large. Finally, we note

[3] https://www.finra.org/rules-guidance/notices/19-12

that the Proposal to delay reporting is not based on any objectively collected evidence on the prevalence of frontrunning or of its costs to dealers and their clients.

We turn now to our concerns about delayed price reporting. Delayed reporting of large trade prices would make it easier for dealers to distribute a large block because the investors to whom the dealers distribute the block ("receiving investors") would have less information about the value of the bond. The dealers would profit from this information advantage. They might pass on some of the value of their information advantage to the block initiators (many of whom are better informed than the dealer) in the form of better prices.

Stated more abstractly, information is power, and power produces profits. The proposed change would transfer power and thus wealth from receiving investors, who are typically smaller participants, to large dealers and their large block initiating clients. The Proposal thus would not promote interests of smaller participants in the market, which is inconsistent with "level the information playing field," a concept that several members of the Commission have stated they hope to promote. Examples of receiving investors who the proposed reporting delay would disadvantage include:

- Retail investors and smaller institutional investors,
- Institutions that increasingly use algorithms to split large orders to obtain better prices over time,
- Small (traditional) swap dealers, and
- Non-traditional liquidity suppliers in electronic platforms.

We note that delayed trading reporting increases price uncertainty. The block trade thresholds under the Proposal would delay public reporting for over 30% of the trading activity by notional value. Delayed block price reporting would expose both buy- and sell-side participants to the risk of transacting at terms inferior to those that they would accept had previously completed block trades been reported on a timely basis. Limited information on large transactions is particularly problematic during periods of market stress (e.g., the COVID-19 pandemic weeks) when the benefit of timely pricing information is large. At such times, price transparency helps ensure that market makers continue to participate in the markets, facilitate liquidity transfer, and stabilize prices.

We recognize that the market impact of quickly buying or selling large blocks can be significant because traders must find counterparties to offset their positions. But we also know that traders can reduce that impact by trading slowly. Giving dealers more time to divest facilitated blocks might reduce their potential impact on price, but we note that dealers acquire this problem only because they take it from the large block initiators. We do not believe that the market structure should favor large traders to the detriment of smaller traders. Large traders can minimize the costs of selling their blocks by breaking them into smaller pieces and selling them in parts over time just as they commonly do in equity, futures, and currency markets.

We also are concerned that delayed dissemination of block trade reports can mislead the market about supply and demand conditions when dealers distribute the block in smaller trades for which trade

reports are immediately disseminated. For example, if a dealer crosses a $25 million swap (i.e., one that exceeds the block trade threshold) from one seller to five buyers each buying $5 million (i.e., trades does not exceed the block trade threshold) on a riskless-principal basis, under the Proposal, the dissemination of the $25 million dealer buy report would be delayed but each of the $5M dealer sales reports would be immediately published. The immediately disseminated reports would give the appearance of surplus buying demand and the possibility that one or more dealers have been left short facilitating this customer demand. The response to such reports could artificially push the swap price higher, at least until the $25 million dealer buy trade is reported two days later. This issue is especially important to smaller dealers who typically do not participate in block trades. Delayed dissemination of trade reports would make it more difficult for smaller traders to compete effectively with larger dealers who see a larger fraction of the order flow.

Finally, we are concerned that the proposed change would increase trade sizes. The delayed reporting of large trades would encourage traders to trade blocks with qualifying size rather than smaller blocks or blocks broken into smaller pieces. The Proposal, if implemented, thus would decrease price (and size) transparency by more than the current trade size distribution would suggest, and it could distort standard incentives to trade slowly and more responsibly.

The Proposal Is Not Supported by Academic Evidence on Post-Trade Transparency

A large body of academic research supports the conclusion that timely reporting of transaction data levels the playing field, making important information available to all market participants. Transparency is particularly beneficial to smaller, less sophisticated participants who are typically at an information disadvantage in opaque markets. In the case of corporate bonds, public reporting of transaction data via the TRACE system between 2002 and 2005 led to large reductions in customer's trade execution costs for all transaction sizes.[4] Even institutional investors transacting in block sizes experienced large (50%) reductions in trade execution costs around TRACE initiation. Further, the introduction of trade reporting facilitated greater competition among dealers, and in particular, helped the smaller dealers gain market share and close the trading cost gap enjoyed by large dealers.

The introduction of post-trade transparency has also been shown to be associated with reduced trading costs in CDS markets, the TBA MBS market, and the Rule 144A corporate bond market – all markets dominated by institutional participants.[5] In the case of 144A corporate bonds, lower trading costs are observed even for trades sizes that exceed $10 million. Of particular relevance to the evaluation of the Proposal, no evidence shows a decline in block trading volume, decline in dealer's capital commitment, or any change in dealers' propensity to facilitate block trades.

[4] See Bessembinder, Maxwell, and Venkataraman (2006), Edwards, Harris, and Piwowar (2007) and Goldstein, Hotchkiss, and Sirri (2007).

[5] For CDS markets, see Loon and Zhong (2016); for the TBA MBS market, see Schultz and Song (2019); and for the Rule 144A corporate bond market, see Jacobsen and Venkataraman (2018).

Appendix A provides a list of related academic studies on post-trade transparency in the corporate, municipal, and structured bond markets. The key result from academic studies is that the benefits of timely public reporting of transactions have been observed

- in many markets,
- using different data sets,
- using different empirical methods,
- during different sample periods
- for both retail and institutional investors.

We believe that the wealth of evidence from these academic studies should inform the evaluation of the Proposal. We see nothing special about swap contracts or the markets in which they trade that would justify ignoring the widespread, well-accepted evidence of the benefits of post-trade transparency in so many markets.

An Alternative Recommendation

Size information is important primarily because large size helps ratify the price report. The additional value of knowing the exact size of a trade is small compared to just knowing that the trade is large. If we accept, as proponents of the Proposal assert, that dealers need additional protection from frontrunners when distributing large blocks, we believe that a different change in disseminating trades reports could accomplish this objective without disadvantaging receiving investors. The CFTC could simply decrease the current size reporting thresholds. The decrease in reported sizes would protect the dealers by further hiding the full sizes of the blocks that they have purchased and must distribute. But the receiving investors still would know the actual trade prices. This proposal would decrease size transparency, but the harm to the market would be small while potentially providing the intended protection to dealers.[6]

FINRA's Proposal Pilot to Delay Block Transactions Does Not Enjoy Broad Support from Industry

During the FIMSAC meeting on June 1, 2020, FINRA provided a summary of the comment letters received from market participants on FINRA's proposed pilot to delay reporting of block trades in corporate bonds by 48-hours.[7] Of the comment letters that FINRA received on the proposal, 25 commenters opposed the 48-hour dissemination delay on many grounds. The more important issues discussed include that delayed reporting would discriminate against all but the largest firms, increase information asymmetry, cause market distortions, increase systemic risk, negatively impact bond valuation services, harm the market for derivative products, and create compliance challenges. Among the large buy-side firms opposing the 48-hour TRACE dissemination delay are Vanguard, Federated, Dimensional, AQR, T- Rowe Price, and CFA Institute. The large sell-side firms include Citadel, Jane Street, and Millennium Advisors. Only five commenters supported FINRA's proposed pilot. Given that the

[6] See Hollified, Neklyudov, and Spatt (2020) for empirical evidence.
[7] https://www.sec.gov/spotlight/fixed-income-advisory-committee/finra-block-pilot-comment-summary.pdf

economic implications of the CFTC Proposal are similar to FINRA's proposed pilot, these comment letters from large industry participants should inform evaluation of the Proposal.

Conclusion

Trade price transparency is essential to well-functioning capital markets. Substantial empirical evidence shows that public dissemination of TRACE trade reports in the corporate bond market has saved public investors about $1B/year. We believe that threatening the cost savings due to timely public disclosure of important information would be unwise.

Large dealers in all markets have regularly opposed timely reporting of block trade prices because transparency reduces their pricing power. In contrast, timely reporting of block trades helps buy-side traders better understand market conditions so that they can arrange trades on more favorable terms. It also allows smaller sell-side dealers to compete on a more level playing field with larger dealers. Many small dealers in aggregate regularly supply much liquidity.

We note that although large equity blocks represent substantially more credit risk than do similarly sized fixed income blocks, the U.S. equity markets do not exempt large blocks from printing requirements. While we recognize the important differences in the cash flows associated with fixed income and equities, differences in how instruments obtain their values do not bear on the importance of timely public trade price reporting in any market.

Many alternative reasons explain why large fixed-income dealers are unwilling to commit as much capital as they previously committed to the capital markets. The primary explanations include (a) the growth of electronic trading and with it increasing competition from non-traditional proprietary traders who now provide substantial competition to traditional dealers, and (b) post-crisis reforms in bank regulation, including the Volcker Rule and Basel III requirements, that have affected willingness or ability to commit capital by bank-affiliated dealers. To avoid the second problem, many fixed income traders have left banks to start or join proprietary trading firms subject to less prudential banking regulation. Secondary reasons include the decrease (until recently) in bond volatility due to low interest rates and substantial economic growth. These processes are decreasing the costs of bond liquidity to traders. The fact that traditional bank-affiliated dealers participate in the markets less than they once did should not concern regulators. The modernization of other markets led to similar results with substantial improvements in liquidity. Regulatory attention should focus instead on reducing institutional frictions that impede broad investor participation in liquidity provision.

Although we oppose delaying trade price reporting, we believe that if the CFTC wants to consider delaying trade price reporting for large transactions, it should first conduct a study to identify and measure the purported costs of front-running to the large dealers. If the CFTC cannot find significant costs, it should take no further action on the Proposal. If the CFTC finds significant costs, it then should undertake a pilot study with an adequate control sample that can produce statistically meaningful results about the potential costs of delayed price reporting to other traders. Simply changing the rules to see what will happen is not acceptable. Unrelated changes in market conditions will inevitably ensure that multiple factors could account for any subsequent changes in market quality. Finally, we note that

pilot studies are expensive. We do not believe that every possible issue deserves a pilot study, and especially those for which the underlying issues are well understood.

For the many reasons stated above, we do not see how giving power to large dealers (and indirectly to their large block-initiating clients) while disadvantaging receiving investors and smaller dealers produces any significant value to the economy or the capital formation process. We believe that implementing the Proposal is unwise as its costs would be much greater than any reasonably expected potential benefits.

Sincerely,

Larry Harris
Fred. V. Keenan Chair in Finance
USC Marshall School of Business

Kumar Venkataraman
Professor of Finance, Maguire Chair in Energy Management,
Southern Methodist University

Appendix

Related academic studies on the corporate bond market:

- Bessembinder, H.; W. Maxwell, and K. Venkataraman. Market Transparency, Liquidity Externalities, and Institutional Trading Costs in Corporate Bonds" Journal of Financial Economics 82 (2006), 251–288.
- Edwards, A., L. Harris, and M. Piwowar. Corporate Bond Market Transaction Costs and Transparency. Journal of Finance 62 (2007), 1421–1451.
- Goldstein, M., E. Hotchkiss, and E. Sirri. Transparency and Liquidity: A Controlled Experiment on Corporate Bonds. Review of Financial Studies 20 (2007), 235–273.
- Hendershott, T., D. Li, D. Livdan, and N. Schürhoff. Relationship Trading in OTC Markets. Journal of Finance 125 (2020), 683-734.
- Jacobsen, S., and K. Venkataraman. Does Trade Reporting Improve Market Quality in an Institutional Market? https://ssrn.com/abstract=3171056.
- O'Hara, M., Y. Wang, and X. Zhou. The Execution Quality of Corporate Bonds. Journal of Financial Economics 130 (2018), 308-326.
- Hollifield, B., Neklyuduv, A. and C. Spatt, Volume and Intermediation in Corporate Bond Markets, working paper, Carnegie Mellon University (2020).

Related academic studies on the municipal bond market:

- Harris, L. E., and M. S. Piwowar. Secondary Trading Costs in the Municipal Bond Market. Journal of Finance 61 (2006), 1361–1397.
- Li, D., and N. Schürhoff. Dealer Networks. Journal of Finance 74 (2019), 91–144.
- Schultz, P. The Market for New Issues of Municipal Bonds: The Roles of Transparency and Limited Access to Retail Investors. Journal of Financial Economics 106 (2012), 492–512.

Related academic studies on the structured bond market:

- Friewald, N., R. Jankowitsch, and M. G. Subrahmanyam. Transparency and Liquidity in the Structured Bond Market. Review of Asset Pricing Studies 7 (2017), 316-348.
- Gao, P., P. Schultz, and Z. Song. Liquidity in a Market for Unique Assets: Specified Pool and To-Be-Announced Trading in the Mortgage-Backed Securities Market. Journal of Finance 72 (2017), 1119–1170.
- Hollifield, B., A. Neklyudov, and C. Spatt. Bid-Ask Spreads, Trading Networks, and the Pricing of Securitizations. Review of Financial Studies 30 (2017), 3048–3085.
- Schultz, P., and Z. Song. Transparency and Dealer Networks: Evidence from the Initiation of Post-Trade Reporting in the Mortgage Backed Security Market. Journal of Financial Economics 133 (2019), 113–133.