



**Written Testimony of Randolph Snook**

**Executive Vice President**

**Securities Industry and Financial Markets Association**

**before the U.S. House of Representatives**

**Committee on Financial Services**

**Subcommittee on Capital Markets, Securities, and Investment**

**Hearing entitled “A Review of Fixed Income Market Structure”**

**July 14, 2017**

Chairman Huizenga, Ranking Member Maloney, and distinguished members of the Subcommittee, thank you for providing me the opportunity to testify today on behalf of the Securities Industry and Financial Markets Association (SIFMA)<sup>1</sup> and to share our views on the structure and health of the U.S. fixed income securities markets. SIFMA represents a broad range of financial services firms active in the fixed income markets and is dedicated to promoting investor opportunity, access to capital, and an efficient market system that stimulates economic growth and job creation. The U.S. fixed income markets are a fundamental tool for raising investment for businesses, homebuyers, and the federal government itself. This Subcommittee's oversight of the fixed income markets and the regulatory framework that supports them is critical to protecting market efficiency and access to capital.

This testimony will go into more detail on each asset class but let me state up front that the U.S. fixed income markets are truly without parallel. Total outstanding fixed income debt is almost \$40 trillion dollars, with new issuance in the range of \$6 to \$7 trillion per year over the last 5 years. On average \$775 billion of securities are traded each and every day.

This central role played by the U.S. capital markets, and the fixed income markets in particular, contrasts with other major economies, where a far greater proportion of consumer and commercial finance is provided by traditional bank lending.

Changes in the capital markets since the financial crisis, be they changes in risk appetites or regulatory approach, have heightened concerns that our capital markets are not providing the necessary funding to our businesses, individuals, and governments in the most efficient way possible. Private credit extended to households and nonfinancial businesses has grown at a slower pace than in all recoveries in the past 60 years.<sup>2</sup> Small businesses in particular have found it difficult to obtain credit.<sup>3</sup> In its recent report on banks and credit unions, the Treasury Department pointed out that real gross domestic product is only 13% higher than in 2007 and lags previous recoveries.<sup>4</sup>

---

<sup>1</sup> SIFMA is the voice of the U.S. securities industry. We represent the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raising over \$2.5 trillion for businesses and municipalities in the U.S., serving clients with over \$18.5 trillion in assets and managing more than \$67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit <http://www.sifma.org>

<sup>2</sup> Zheng Liu & Andrew Tai, Slow Credit Recovery and Excess Returns on Capital (Fed. Reserve Bank of San Francisco Economic Letter 2016-28, Sept. 26, 2016)

<sup>3</sup> Fed. Reserve Banks of Atlanta, Boston, Chicago, Cleveland, Dallas, Kansas City, Minneapolis, New York, Philadelphia, Richmond, St. Louis & San Francisco, Small Business Credit Survey (Apr. 2017)

<sup>4</sup> U.S. Treasury, A Financial System That Creates Economic Opportunities – Banks and Credit Unions (June 2017), at 6 and 44.

As an example, corporate debt markets have seen robust overall issuance but most of this has been in large deals and the number of smaller new debt issues coming to the market has fallen.<sup>5</sup> Previous SIFMA testimony to this Committee explained that as of a year ago:

- 1) the average size of an investment grade corporate debt transaction approached \$1 billion;
- 2) the number of deals sized above \$2 billion had doubled (since 2010),
- 3) the number of smaller deals had fallen by nearly 50%.<sup>6</sup>

The fact that smaller firms are challenged in effectively financing themselves in the debt market has many potential implications for the economy. Similar difficulties are faced by smaller broker-dealers who play a critical role in the financial markets. Sand has been thrown in the gears of economic growth by regulation such as the Volcker Rule, among other things, and the impact has been disproportionately felt by smaller participants in the market – issuers and market makers alike.

The economy is not functioning as well as it should be at this point in the recovery, and SIFMA believes that policymakers have the ability to improve this situation through tailored recalibration of regulations affecting fixed income markets. This commonsense recalibration could help jumpstart the economy without sacrificing financial stability.

### **Impact of Post-Crisis Regulation**

As SIFMA has frequently stated, we believe that the Volcker Rule as drafted and implemented has impaired beneficial activities (such as permitted market making) and has led many firms to scale back their trading operations as well as their inventories of financial assets. In order to avoid any doubt, firms take a more conservative approach to building inventory or facilitating customer activity than required by the rule. We believe that the Volcker Rule remains a policy prescription in search of a problem and would be better off repealed. However, if it is retained, a more focused approach to definitions of important concepts, such as market making and inventory accumulation, with a review of the compliance regime to better tailor requirements with each firm's business profile would be appropriate.

In addition, while SIFMA supports many of the post-crisis regulatory reform efforts in the area of capital and liquidity and believes that these efforts have enhanced the overall resiliency of the capital markets, now is the time to review how these rules work together—for example by examining how the liquidity requirements work with leverage requirements-- with a particular emphasis on determining where they may be impeding liquidity by targeting the same risk in multiple ways. A review should include these liquidity and leverage requirements but also look at the effects of and interactions with CCAR, Basel III capital rules, and single counterparty credit limits. We firmly believe this sort of clear review of the potential costs of additional requirements which could limit the capital available for lending against any incremental benefits of resiliency should be undertaken

---

<sup>5</sup> See, e.g., “The Two-Speed Economy Still Runs on Two Tracks”, The Clearing House, available: <https://www.theclearinghouse.org/research/banking-perspectives/2017/2017-q1-banking-perspectives/two-speed-economy>

<sup>6</sup> See testimony of Ronald Kruszewski on behalf of SIFMA, Mar. 29, 2017 (available here: <http://www.sifma.org/issues/item.aspx?id=8589965576>)

with respect to capital and liquidity regulation, and are pleased that policymakers have begun to move in that direction.<sup>7</sup>

At the highest level, SIFMA believes that:

- The U.S. fixed income markets are unparalleled in their size and importance. They are the largest source of financing for America's homeowners, consumers, and businesses.
- Fixed income markets continue to adapt to changes in technology, the regulatory environment, and market participant needs.
- Notwithstanding this adaptation, fixed income markets face challenges in continuing to provide the deep liquidity and capital that consumers, businesses, and investors require.
- In order to ensure the continued depth and diversity of the fixed income markets, policymakers should review the myriad regulatory and prudential actions taken since the crisis with a goal to eliminate overlapping or conflicting regulation, capital requirements, and unnecessary activity restrictions.
- This review should include the Volcker Rule, liquidity requirements, leverage requirements, and other rules and regulations that have impaired market efficiency and capital formation.
- Regulators must move very cautiously when considering new requirements and restrictions on activities and participants in the fixed income markets.

## **Overview of the U.S. Fixed Income Markets**

As of the end of 2016 there were almost \$40 trillion of fixed income securities issued in the U.S. outstanding in the market.<sup>8</sup> These include U.S. Treasury securities issued by the federal government to finance operations, securities issued by Ginnie Mae, Fannie Mae, and Freddie Mac to provide mortgage financing for homebuyers, bonds issued by corporations to finance capital investment, and bonds issued by state and local governments to build infrastructure, among others. The fixed income markets also provide an important source of income-producing investments for individual and institutional investors. The steady, predictable income generated by most bond investments is where the fixed income markets get their name.

The fixed income markets are generally segmented by sector according to the category of issuer. The Treasury or government securities market includes debt issued by the federal government. The corporate bond market includes debt securities issued by businesses. The mortgage- (MBS) and asset-backed securities (ABS) markets include securities issued to finance home mortgages, car loans, or other types of loans extended to consumers and businesses. Many but not all MBS are issued and/or guaranteed by Ginnie Mae, Fannie Mae and Freddie Mac. Government agency securities are debt securities issued by government agencies, including Fannie Mae, Freddie Mac, Federal Home Loan Banks, the Farm Credit System and others to carry the missions of the agencies. The municipal

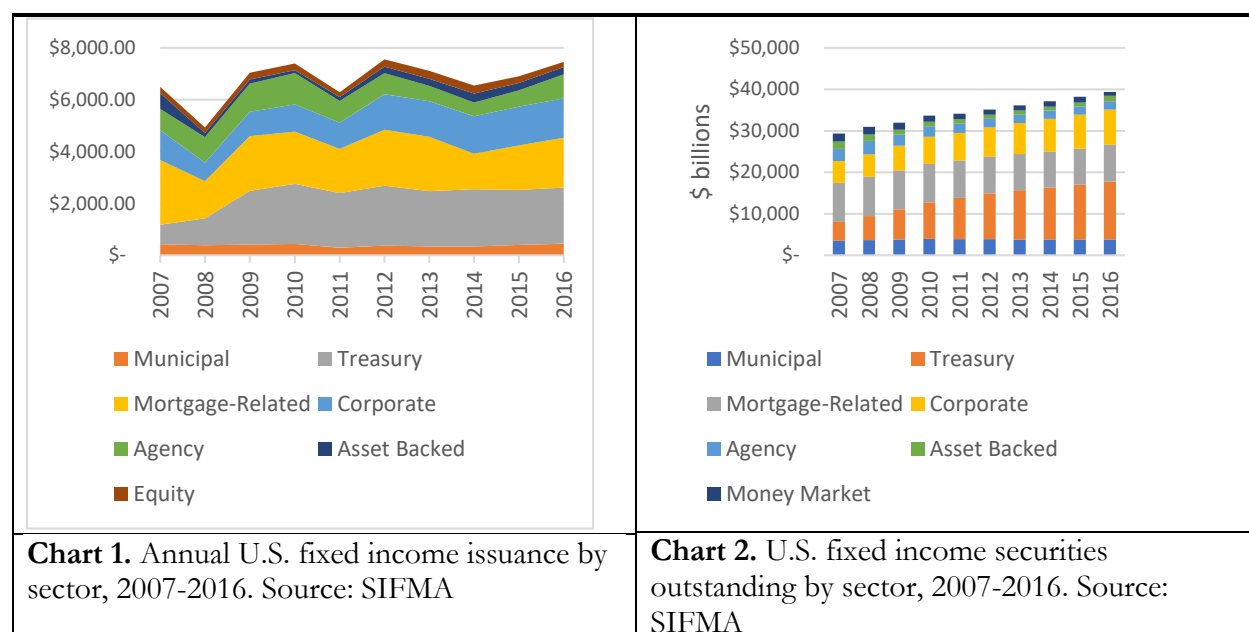
---

<sup>7</sup> See, e.g., <https://www.treasury.gov/press-center/press-releases/.../A%20Financial%20System.pdf>

<sup>8</sup> SIFMA, "US Bond Market Issuance and Outstanding" (June 5, 2017), available at: <http://www.sifma.org/uploadedFiles/Research/Statistics/StatisticsFiles/CM-US-Bond-Market-SIFMA.xls?n=33672>, June 5, 2017.

securities market includes bonds issued by state and local governments to finance investment in infrastructure.

Attributable primarily to the low interest rate environment, issuers sold more than \$7.3 trillion of new fixed income securities in the U.S. market in 2016, the third highest year on record. (See Chart 1) This contrasts sharply with the \$197 billion of equity securities issued in the same year.<sup>9</sup> Issuance in the bond markets occurs practically every day. Companies and governments depend on ready access to capital to respond quickly to business opportunities. For example, it is not unusual for a well known company to issue billions of dollars of fixed securities to finance a new investment with only a few days notice if market conditions are favorable. This kind of ready access to capital promotes growth and is a cornerstone of our economy.

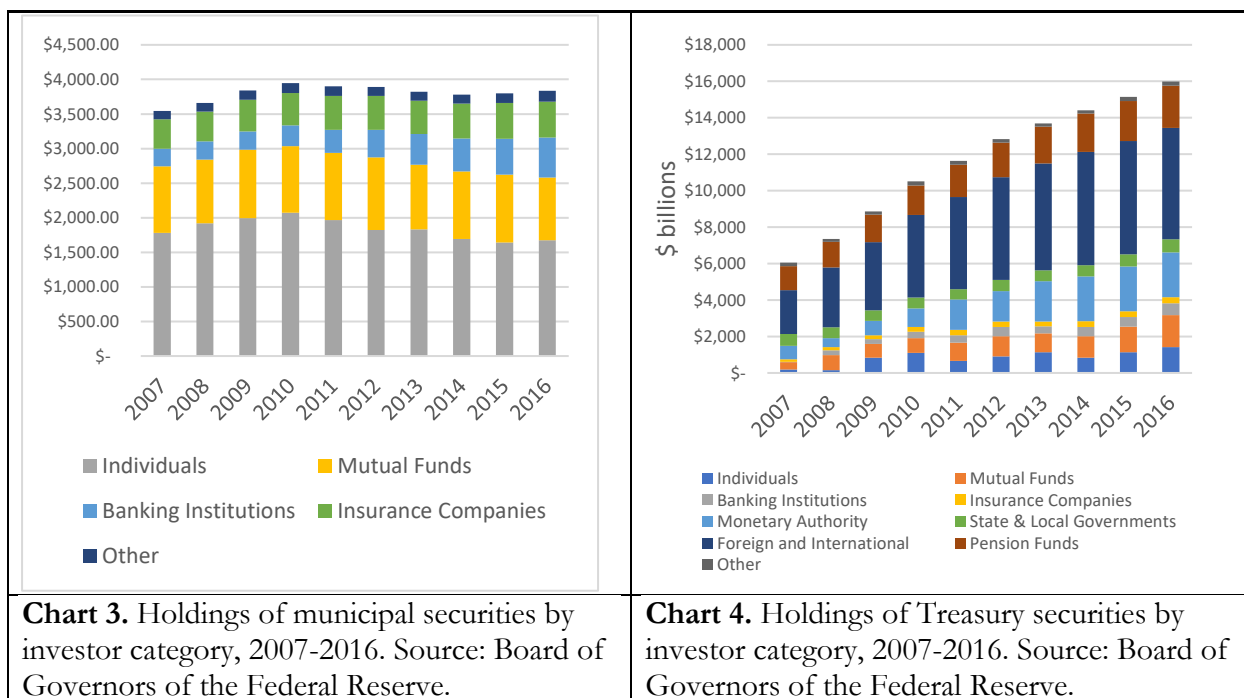


As shown in Chart 2, at the end of 2016 there were \$40 trillion of fixed income securities outstanding in U.S. markets. By comparison, U.S. equity market capitalization at the end of 2016 was approximately \$30 trillion.<sup>10</sup>

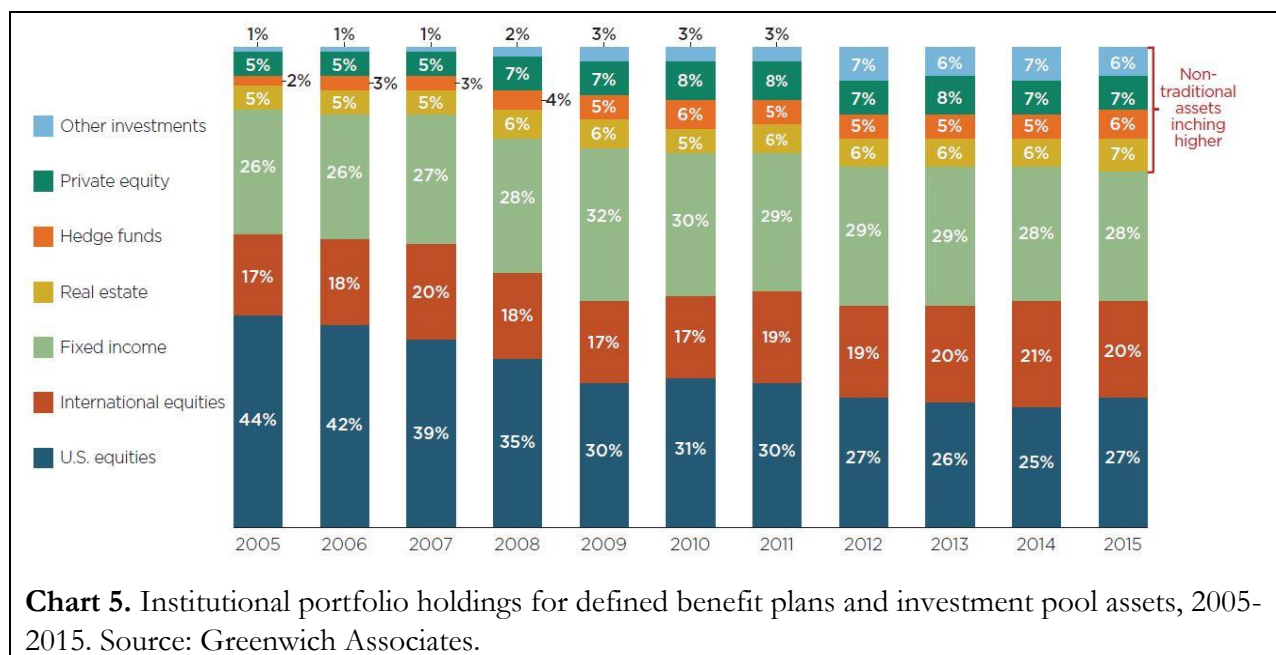
Holdings of fixed income securities vary by sector, but generally include both individual investors and institutions like mutual funds, pension funds, insurance companies and others. Some sectors feature significant participation by individual investors (e.g. municipal securities), whereas others are primarily institutionally based (e.g. Treasuries and securitized products). Data on holdings of the Treasury and municipal bond markets are presented below. (See Charts 3 and 4) These charts show the distinct investor bases of the two markets.

<sup>9</sup> Source: SIFMA

<sup>10</sup> Source: Nasdaq and NYSE.



In 2015 fixed income investment comprised 28% of institutional investors' portfolios. (See Chart 5 below)



## Fixed Income Market Structure Overview

Most fixed income securities have a stated maturity that can range from a week or less to 30 years or more. Investors often buy fixed income investments with a targeted maturity in mind. A life insurance company, for example, may want to match the length of their investments with the timing of claims expected to be paid in the distant future. Families may save for an anticipated future expense like college tuition. However, circumstances change, and sometimes investors may want to exit their fixed income investments before they mature. The “secondary market” exists so that investors who want to sell bonds before they mature can find ready buyers.

The secondary market for fixed income securities differs in important respects from the secondary market for equities. The most important difference is that most fixed income securities trade not on an exchange or national market system but over the counter. While some very small cap companies’ stock also trades over the counter, this accounts for only a tiny portion of all stock transactions. This means that unlike the stock market, where shares are often traded directly between two investors, trading in fixed income securities almost always includes an intermediary, generally a bank or broker-dealer, that buys bonds from one investor and resells them to others.

The over the counter nature of the fixed income market has been its defining structural characteristic and contrasts with the structure of the equity markets. At the end of 2016 there were 5,204 companies whose stock was listed on a U.S. exchange.<sup>11</sup> Each company generally has just one class of common stock outstanding, and most listed equities trade actively. Market makers and specialists ensure that there are active, two-way (buy and sell) quotations available for every listed stock throughout the trading day. In the U.S. municipal bond market, by contrast, almost one million individual bonds outstanding have been issued by tens of thousands of states, cities, towns, school districts, authorities and other state and local “political subdivisions.” Each issuer may have hundreds or, for large, active issuers, thousands of individual bonds outstanding. It is simply not possible for dealers to provide active quotes for the approximately one million municipal bonds at all times as most issues do not actively trade. Similarly, there are over one million corporate bonds and mortgage-backed and asset-backed securities outstanding. The vast majority of fixed income securities do not trade every day. Many bonds go months or even years without trading at all. Indeed, in some cases an investor may buy a bond when it is newly issued and never trade the bond at all before it matures.

That is not to say, however, that the fixed income markets are illiquid. When investor wants to sell a bond, it should be possible to get executable price quotes from one or several dealers on request. Dealers buy bonds directly from customers and keep them in their inventory while they search for a buyer, either an investor or another dealer. In addition, underwriters of fixed income securities typically make markets in securities that they underwrite. While the dealer owns the bond in its inventory, the firm is exposed to the risk that the price of the bond will fall before the dealer finds a buyer. While many dealers use products and strategies to hedge that risk, hedging comes with costs, and hedges are not always perfect. In addition, under banking and securities rules, firms must commit capital against trading positions to provide a “cushion” against any losses. In any case,

---

<sup>11</sup> Source: World Federation of Exchanges

liquidity in the fixed income markets generally depends on the ability and willingness of dealers to commit capital and take on risk in order to buy bonds from customers who want to sell.

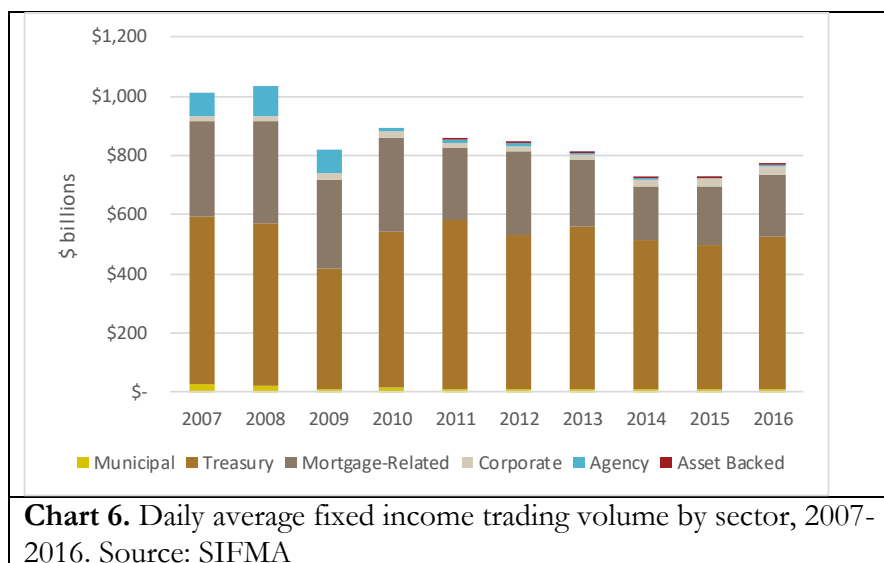
Another difference between equity and fixed income trading is how dealers are compensated. In the stock market, many trades are brokered. Dealers match buyers and sellers of securities but usually do not take shares into inventory or take on any market risk and earn commissions for executing trades for customers. In the fixed income markets, by contrast, dealers rarely earn commissions for secondary market transactions. Instead, a dealer buys a bond from a customer at one price, the “bid,” and resells the bond at a slightly higher price, the “offer” or “ask.” In simplistic terms, this difference between the bid and ask prices, known as the “markup,” is a reference point for the dealer’s compensation for executing the transactions and taking the market risk associated with the position. Conversely, for the customer selling their bond to a dealer, the dealer’s compensation is known as a “markdown.” The difference between the bid and ask prices, the “bid-ask spread,” can also be an indication of market liquidity. The more liquid the instrument and the less risk the dealer takes on, the smaller the bid-ask spread.

The best example over an active and deep fixed income market is the “on-the-run” market for Treasury securities. On-the-run Treasuries are the most recently issued of the various securities the Treasury Department sells regularly (4-, 13-, 26- and 52-week bills, 2-, 3-, 5-, 7-, and 10-year notes, 2-year floating rate notes, 30-year bonds, and 5-, 10-, and 30-year Treasury Inflation Protected Securities, or TIPS). The market for on-the-run Treasuries is very large and active and is dominated by large institutional investors, investment funds, banks and others. Around 2/3 of all fixed income trading volume in the U.S. is in the Treasury market, and the vast majority of that activity is in on-the-run issues. The on-the-run Treasury market is the most active and liquid securities market in the world. Bid-ask spreads for round-lot institutional trades are near zero, meaning there is virtually no cost to transacting on-the-run securities. Also, because this segment of the market is so liquid and active, alternative forms of electronic trading have evolved that allow investors to trade directly with each other without dealer intermediation.

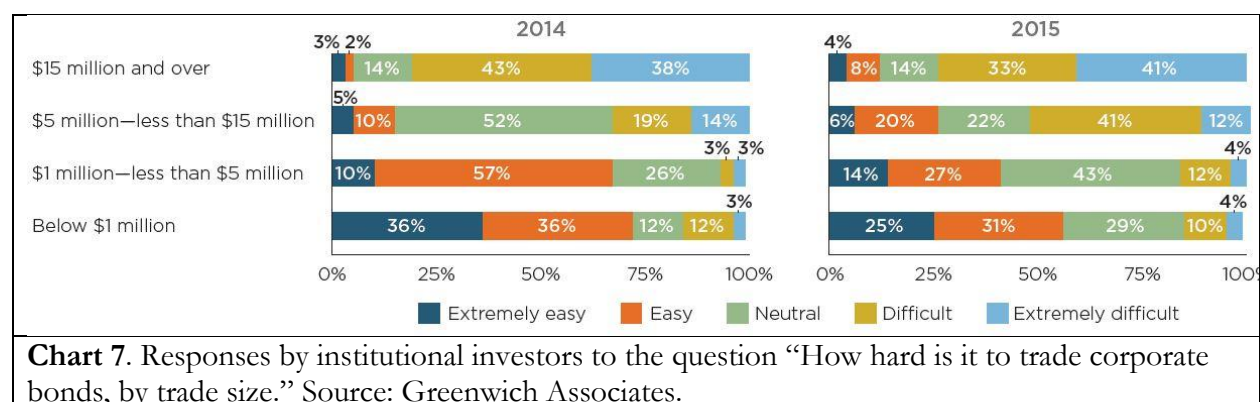
## **Market Liquidity**

One way to define liquidity is in relation to the ability to execute a large secondary market transaction at a reasonable cost and without significantly affecting the price of the security. Indications of liquidity can be measured by various indicators, including trading volume, bid-ask spread, dealer inventories and other measures. However, the ultimate measure of liquidity is in part subjective and depends on market participants’ perceptions of the ease and cost of executing institutional size trades.





In 2014 and 2015 surveys of corporate bond investors, Greenwich Associates asked about the ease of trading corporate bonds by size.<sup>12</sup> In each year of the survey, over 75% of investors found it “difficult” or “extremely difficult” to trade larger-size blocks of corporate bonds. (See Chart 7 below.) by trade size.” Source: Greenwich Associates.



A number of factors affect market liquidity, and market liquidity can improve or deteriorate depending on these factors. These include, among others:

- Regulation. Regulation of dealer activity can affect liquidity. For example, the Volcker Rule limits on trading by banks in some cases constrain dealers’ ability to take on trading positions and build inventory necessary for market making. Capital and leverage rules also limit dealers’ ability to finance positions held in inventory, and can clearly limit their ability to commit to customer trades.
- Monetary policy. In the wake of the financial crisis and the 2008-2009 recession, the Federal Reserve undertook an aggressive policy of “quantitative easing” whereby it purchased

<sup>12</sup> Greenwich Associates, “Understanding the US Fixed Income Markets” Oct. 2016, at 9.

significant volumes of Treasury securities and Agency MBS. One goal of this effort was to reduce yields in the markets for the securities that are purchased and drive investment from these safe haven markets into other markets, such as corporates, through the so-called portfolio balance channel. Importantly, the Federal Reserve is a buy-and-hold investor, so bonds it purchases are effectively removed from tradeable float. Accordingly, from a whole-market perspective impacts on liquidity of these operations are mixed – in some markets (e.g., TBA MBS where Federal Reserve ownership approached one-third of available securities the market), Federal Reserve activity would crowd out other investment and have the effect of reducing liquidity for participants, while it would simultaneously increase demand and liquidity in other markets as investors shift their activity to them.

- Market activity. When many investors attempt to sell bonds in the secondary market at the same time, liquidity usually suffers. Dealers have a limited balance sheet capacity to absorb customer requests to sell bonds, and when significant trade flow imbalances arise, dealers may be constrained in their ability to provide liquidity to the market. Since liquidity in most sectors depends heavily on dealers committing capital and taking risk positions, dealers withdrawing from the market necessarily dampens liquidity. This affect may be exacerbated in a market where prices are declining, since neither dealers nor investors want to be exposed to market risk under those conditions.
- Dealer risk management. While regulations and capital requirements can dramatically affect liquidity, non-regulatory changes in dealer behavior can also affect liquidity. Since the financial crisis many dealers have reduced the sizes of their balance sheets and, as a matter of prudent risk management, limited their own exposure to market risk, which can limit their ability to absorb customer positions.

## **Fixed Income Market Regulation**

The U.S. fixed income markets are strongly regulated with ten federal agencies and self-regulatory organizations involved in rulemaking or enforcement regarding fixed income securities and related products. SIFMA believes that a wave of new laws and regulations implemented after the financial crisis, that were designed to address financial stability concerns and not targeted directly at fixed income markets, have nonetheless constrained dealers' ability to provide liquidity. These include, among others: CCAR, Basel III capital rules, leverage ratio, liquidity coverage ratio, single counterparty credit limits and the Volcker rule. We have not yet seen how the combined effects of these regulations will affect fixed income liquidity in a truly stressed market environment but many market commentators and policymakers have expressed concerns. As mentioned above, we believe the time is right for a review of the effects of these rules and requirements.

What follows is a brief outline of how fixed income markets are regulated.

- All broker dealers who participate in the fixed income markets are required to be registered with the U.S. Securities and Exchange Commission (SEC) and one or more self-regulatory organizations (SROs) such as the Financial Industry Regulatory Authority (FINRA) or the Municipal Securities Rulemaking Board (MSRB). The SEC also oversees mutual fund

companies and registered investment advisors and Automated Trading Systems (ATSs). The SEC and FINRA also regularly examine bond dealers to check for regulatory compliance.

- Bank regulators, including the Federal Reserve Board (the “Fed”), the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) make rules that impact bank and bank holding company participation in the markets, including areas such as capital and liquidity.
- The U.S. Treasury Department is the primary rule maker with regard to the market for U.S. government securities.
- The Commodity Futures Trading Commission and the National Futures Association oversee the markets for fixed income derivatives.
- The Federal Reserve Bank of New York exercises oversight of the primary dealers.
- Finally, the Department of Labor oversees entities that manage investments that fall under the Employee Retirement Income Security Act of 1974 (ERISA).

In the area of investor protection, U.S. regulators have several areas of focus. FINRA and the MSRB have rules in place that require dealers to have a “reasonable basis to believe” that investments they recommend to customers are suitable. In addition, dealers are required to provide investor customers with prospectuses, official statements or other key disclosure information at the time they recommend an investment. FINRA and the MSRB also have rules in place to help ensure that investors pay or receive fair prices for the securities they buy or sell and rules that require dealers to report relevant information about an investment to a customer at the time of a transaction, as well as certain best execution obligations. The SEC oversees mutual fund companies and registered investment advisors to ensure that investors receive clear information about investments in their funds and that asset managers adhere to a fiduciary duty with regard to customers’ investments.

The SEC has a panoply of disclosure rules in place that (among other things) require an issuer of registered securities to produce a prospectus at the time that bonds are offered for sale. SEC rules also require corporate securities issuers to publish annual, audited financial statements, quarterly financial statements and notices of certain events that could affect the value of their securities.

Securities are also issued in non-registered forms, most notably in the so-called Rule 144A market. While these securities are not registered with the SEC, and not necessarily subject to disclosure rules applicable to registered offerings, they remain subject to the SEC’s anti-fraud regulations such as rule 10b-5 and other requirements that provide investor protections. SIFMA members believe that, in some sectors, burdensome and unnecessary increases in registration requirements have increased risk to issuers and underwriters, driving issuance into the unregistered markets (e.g., private-label MBS).

Disclosure rules in the municipal bond market do not apply directly to issuers. However, the SEC has rules in place designed to help ensure that both at the time of issuance and on an ongoing basis, investors have ready access to issuer financial and risk information. Financial information from corporate issuers is available to investors free on the SEC’s EDGAR platform, and municipal bond information is available on the MSRB’s EMMA platform.

In the area of price transparency, both FINRA and the MSRB have rules in place that require dealers to report the prices of most agency, corporate, mortgage- and asset-backed, and municipal bond

transactions to a central repository. This trade information is publicly disseminated for most of these markets through FINRA's TRACE system and the MSRB's EMMA platform, in real-time in the case of agency, corporate and municipal securities.

Prudential regulation is mostly the purview of the SEC (for broker-dealers) and the federal banking agencies, the Fed, the OCC and the FDIC (for banks). These agencies have in place rules that require broker-dealers and banks to hold minimum levels of capital against the investments they hold, providing a "cushion" against losses the bank may suffer if positions they hold perform poorly. The bank regulators' "risk-based" capital rules account for the relative risks of various categories of investments, and in general require banks to hold more capital against riskier positions. Banking agencies also have rules in place to limit leverage and to help ensure that banks have sufficient liquid investments that they can sell quickly if the need arises. In addition, the "Volcker Rule," a provision of the Dodd-Frank Act, prohibits banks from engaging in "proprietary trading" of many categories of investments, including certain fixed income securities.

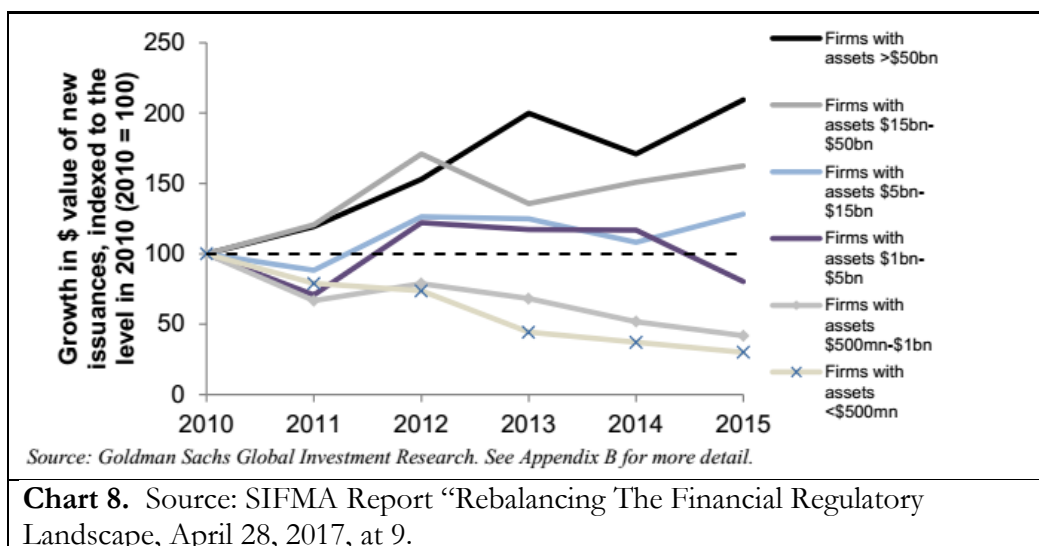
## **Corporate Bond Market Overview**

The corporate bond market provides the means for businesses to raise capital to finance investment in new capital assets. The primary market is active and in recent years and has experienced significant growth given the interest rate and economic climate with both a rise in annual issuance (together with a rise in the average deal size) and a commensurate rise in the dollar volume of bonds outstanding. For example, investment grade corporate bond issuance grew from \$1,032 billion in 2012 to \$1,286 billion in 2016 (a 24.6% increase) while the size of the overall corporate bond market or dollar volume of bonds outstanding was approximately \$8.5 trillion in 2016, a 21% increase since 2012 (i.e. \$7 trillion). In 2016 average daily trading volume in U.S. corporate bonds was \$30.0 billion. By comparison, average daily stock market trading volume in 2016 was \$273 billion. Looking at trading in relation to the size of the market, in 2016 average daily corporate bond trading volume represented 0.35% of total volume outstanding at the end of the year. In the equity market, trading volume represented 0.94% of end-of-year market capitalization.<sup>13</sup>

As discussed in the introduction, access to the market for smaller issuers has declined in recent years, as growth (or decline) in issuance is clearly correlated to issuer size. (See Chart 8)

---

<sup>13</sup> Derived from SIFMA statistics, available at <http://www.sifma.org/research/statistics.aspx>



Secondary market trading volume in most fixed income markets is unsurprisingly dominated by trading in newly issued securities. Corporate bonds tend to trade very actively in the weeks immediately following a new issuance and trading activity wanes considerably as bonds come to rest with more buy-and-hold investors. Similar to the municipal securities market, it is not uncommon for individual bonds to trade very infrequently in the secondary markets which can make price discovery more challenging.

Market structure for corporate bonds, which had historically relied heavily on dealer intermediation over the phone, has been evolving in recent years to adapt to a host of regulatory and market forces. Importantly, there has been significant competition and innovation in electronic trading platforms and increased investment in data aggregation and client connectivity among market participants. There are now likely to be upwards of 20 operational electronic platforms serving the corporate bond space compared to only a handful in 2010<sup>14</sup> and the electronic trading of investment grade corporate bonds has grown from approximately 8% in 2013 to 20% in 2015<sup>15</sup>. A number of new electronic trading platforms have functionality that allows any market participants, dealers or investors, to trade directly with each other. While adoption of electronic trading has been incremental, the growth in electronic trading platforms for corporate bonds will most certainly change the way many corporate bonds trade over time even with some or even significant continued reliance on dealer intermediation. Electronic trading has been dominant in retail-size transactions, but institutional market participants have [begun] increased their use of new trading mechanisms as well, albeit slowly. The market share of the top 10 dealers in what FINRA categorizes as “more active” corporate bonds is 69%, while the same measure is 56% in what they classify as “less active” corporate bonds.<sup>16</sup>

<sup>14</sup> SIFMA, 2016 Electronic Bond Trading Report, (Feb 2016), available at: <http://www.sifma.org/issues/item.aspx?id=8589958906>

<sup>15</sup> Greenwich Associates, “The Continuing Corporate Bond Evolution”, (Q4 2015). Please note that Greenwich Associates interviewed 1,063 US Institutional Investor active in Fixed Income between February and April 2015 to gather the information on Corporate Bond electronic trading.

<sup>16</sup> FINRA, Analysis of Securitized Asset Liquidity, (June 2017), at 14.

There has been also an increasing focus among corporate bond market participants on better data capture and more efficient use of trade data to aid in price discovery and in finding ready buyers, and a marked increase in the availability and utilization of pricing systems in that regard to both price bonds and measure best execution.

New market regulations, especially the Volcker Rule and rules governing capital and liquidity, have affected dealers' willingness to make markets and readily commit capital in corporate bonds. Unsurprisingly, the New York Federal Reserve Bank's Liberty Street Economics team recently summarized a separately published study that found that institutions more affected by post-crisis regulation are less able to intermediate customer trades.<sup>17</sup> Compressed bid-ask spreads are often cited as evidence of continued strong liquidity and an efficient market. However, liquidity can be measured in a number of ways and one metric won't give an accurate picture of the health of the marketplace as a whole. As the Greenwich Associates survey result shown in Chart 7 suggests, a significant percentage of survey participants believe larger trade sizes are difficult to execute. A 2015 FINRA Analysis on Corporate Bond Liquidity also indicated there is evidence that finding liquidity is now associated with smaller trade sizes, more transactions and larger dealer networks and while the absolute number of block trades continues to increase, the proportion of block trades to total volume is also falling as is the average trade size.<sup>18</sup> Importantly, these reference points may reflect a market in transition where liquidity is more dynamic and where market participants are trying to adapt.

## **Corporate Bond Market Policy Questions**

New market regulations, especially the Volcker Rule and rules governing capital and liquidity, have affected dealers' willingness to make markets and readily commit capital.

Recently published data shows that the Volcker Rule has impacted firms' ability to make markets and provide market liquidity—particularly in times of stress. A recent Federal Reserve staff paper concluded that “the Volcker Rule has a deleterious effect on corporate bond liquidity and dealers subject to the Rule become less willing to provide liquidity during stress times.”

This adverse impact on market liquidity will cause the greatest problems in times of stress. During times of stress, financial institutions will be disincentivized from providing liquidity, precisely when it is most needed, if trading in a stressed environment subjects them to regulatory risk and potential second-guessing resulting from the unclear and complex standards of the current Volcker Rule.

Also of relevance to this discussion is the recent FINRA proposal to modify Rules 2241 and 2242 governing investment research.<sup>19</sup> FINRA's proposal would to create a limited safe harbor for specified brief, written analysis distributed to eligible institutional investors that comes from sales

---

<sup>17</sup> New York Fed's Liberty Street Economics blog published on the Capital Markets page: Dealer Balance Sheets and Corporate Bond Liquidity Provision, (May 2017), available at <http://libertystreeteconomics.newyorkfed.org/2017/05/dealer-balance-sheets-and-corporate-bond-liquidity-provision.html>

<sup>18</sup> FINRA published an Analysis on Corporate Bond Liquidity, available at: [https://www.finra.org/sites/default/files/OCE\\_researchnote\\_liquidity\\_2015\\_12.pdf](https://www.finra.org/sites/default/files/OCE_researchnote_liquidity_2015_12.pdf)

<sup>19</sup> FINRA Regulatory Notice 17-16, “Desk Commentary Safe Harbor,” April 2017.

and trading or principal trading personnel but that may rise to the level of a research report, known as “desk commentary”. The proposed safe harbor would be subject to conditions, including compliance with a number of the Rule 2241 or Rule 2242 provisions to mitigate research-related conflicts. In addition, the proposed safe harbor would require firms to include a “health warning” on desk commentary and to obtain negative consent from eligible institutional investors to receive such commentary.

In our response to the FINRA proposal we argued that that certain “conflict management” provisions relating to investment banking should be eliminated and modified because these provisions, as currently contemplated, would preclude sales and trading personnel who author eligible desk commentary from engaging in many ordinary course activities.<sup>20</sup> These restrictions may be particularly onerous for smaller firms that have limited resources and are less likely to have dedicated investment banking personnel with certain structuring expertise that exists in sales and trading.

While we provided substantive and constructive comments to the proposal, we are not aware of any substantial investor concerns that have arisen from historical or existing desk commentary content or perceived conflicts of interest to warrant the proposal and we remain concerned that valuable communication tools could be unnecessarily stifled to the detriment of the marketplace. We believe that most desk commentary does not risk technically being considered a research report. From our perspective, most desk commentary lacks analysis and to the extent desk commentary contains analysis, it would not be sufficient to make an investment decision.

Finally, FINRA recently issued a request for comment as part of its FINRA360 initiative intended to streamline FINRA’s rules that affect the access to capital among securities issuers.<sup>21</sup> In our response<sup>22</sup> we argued, based on our member firms’ experience, that FINRA’s debt research rule has eroded the frequency and quality of interactions between debt research and trading desk personnel, putting both at a significant information disadvantage. Given the relative complexity of the debt market and the breadth of debt security classes, debt research analysts need access to current market information from traders, and traders need research analyst input to accurately price positions for clients and manage firm risk.

This issue is particularly acute when significant news stories or corporate events are announced, and the absence of guidance from an analyst can prejudice a trader’s ability to price debt securities in real time. Additionally, the absence of this information negatively affects investors’ ability to make informed decisions on debt securities in their portfolios, constraining market liquidity in less liquid securities or during times of market stress.

Although FINRA permits certain interactions between research and trading, the boundary of permitted and prohibited interactions is confusing and does not go far enough to give firms comfort that certain communications are appropriate, thus discouraging debt analysts from engaging

---

<sup>20</sup> Letter from Sean Davy, SIFMA, to Jennifer Piorko Mitchell, FINRA, on Desk Commentary Safe Harbor from FINRA Equity and Debt Research Rules, May 31, 2017.

<sup>21</sup> FINRA, Regulatory Notice 17-14, “Capital Formation” (April 2017).

<sup>22</sup> Letter from Sean Davy, SIFMA, to Jennifer Piorko Mitchell, FINRA, on Request for Comment on FINRA Rules Impacting Capital Formation (June 6, 2017).

in even permissible interactions. FINRA should revise the rule or otherwise issue guidance to provide both clarity and greater flexibility to the interactions between research and trading to avoid these unnecessary impediments.

## **Treasury Market Overview**

The importance of the U.S. Treasury market to the national—indeed, the global—economy cannot be overstated.<sup>23</sup> This market is unique and provides key functions that underlie financial markets throughout the world.

The U.S. Treasury market, the largest segment of the fixed income market, continues to function well in its role providing the benchmark risk-free rate for the global economy. This unique, resilient, and robust market serves multiple roles including as the transmission mechanism for monetary policy, as a safe-haven investment particularly during times of financial stress, and, most importantly, as the source of stable and efficient and low-cost funding for the Federal government. Treasury securities also underpin the new prudential regulatory framework for liquidity of U.S. and many other global financial institutions that has made our financial system significantly more resilient. Recent reviews of the changes in this market have noted the participation of new types of participants and a significant move to electronic dealing.

Given the importance of this market, continued study and review of these changes is necessary to ensure that the Treasury market remains the efficient centerpiece of the economic framework. Any changes to regulation should be carefully calibrated to support both the resiliency and the role of the Treasury market and recognize the unique structure and auction process that has allowed the Treasury to finance government activity at a low cost to taxpayers. We note recent market improvements, most notably the collection, set to begin in July 2017, of secondary market transaction data for use by Treasury and the regulators and supervisors. Additional changes, including public dissemination of secondary market transaction data, need further careful study to ensure that no harm comes to this market.

Treasury's ability to borrow to finance the federal government's debt is built around a truly unique, principal-based market structure, one that is not easily (or appropriately) comparable with more traditional agency (e.g., equities) markets. The fundamental starting point of this market rests in the Treasury auction process.

Treasury has structured the auction process to minimize government costs by promoting broad, competitive bidding. Primary dealers—banks and broker-dealers that have been approved to trade in U.S. Treasuries with the Federal Reserve Bank of New York (New York Fed)—have traditionally constituted the largest group of buyers in such auctions (bidding on behalf of their own accounts or

---

<sup>23</sup> Our description of the Treasury market is drawn from the SIFMA/ABA letter, dated April 22, 2016, in response to the Treasury's 2015 Request for Information. The letter is available at <http://www.sifma.org/comment-letters/2016/sifma-submits-comments-to-the-treasury-in-response-to-rfi/>. For a comprehensive description of the market and market participants, see "Emerging Issues in the Functioning of the US Treasury Market," April 22, 2016, published by Promontory Financial Group and available at [http://www.promontory.com/Articles/Insights/4/22/16\\_-\\_Emerging\\_Issues\\_in\\_the\\_Functioning\\_of\\_the\\_US\\_Treasury\\_Market/?terms=treasury%20market](http://www.promontory.com/Articles/Insights/4/22/16_-_Emerging_Issues_in_the_Functioning_of_the_US_Treasury_Market/?terms=treasury%20market).



on behalf of identified customers).<sup>24</sup> Other direct auction bidders include investment funds, pensions and retirement funds, insurance companies, foreign accounts and others. Primary dealers are, however, the only market participants who are obligated to participate in all auctions of U.S. government debt, with all bids to be made (at a minimum), for an amount of securities representing their pro rata share of the offered amount.

The New York Fed further expects primary dealers to act as “responsible counterparties and market participants in their overall conduct and support of market efficiency and liquidity.” The obligation to support market liquidity extends not only to on-the-run securities, but also to a host of less liquid off-the-run securities. In meeting those obligations set forth by the New York Fed, and in attempting to satisfy market and client demands, primary dealers are frequently required to commit capital in significant size. Principal trading activity in the “when-issued” market, during auctions, in the aftermarket of auctions, and in the secondary market (including with respect to off-the-run securities) correspondingly requires these dealers to hedge their positions with other treasury products (both in the specific security and other related securities) on a confidential basis. The ability of primary dealers to do so is critical to the overall functioning of the U.S. Treasury market and to helping maintain appropriate levels of liquidity in this market.

Other market participants are not similarly bound by the market-making obligations that put primary dealers in a position of providing both buy and sell quotes on a more-or-less continuous basis. Corporate hedgers and hedge funds, for example, seek to hedge specific business risks but do not serve clients as in a typical broker-dealer business model, and are generally liquidity takers, rather than liquidity providers. Principal trading firms (PTFs) similarly do not serve clients, but play a more pronounced role in providing liquidity, trading for their own accounts and in volume to maximize profit on all trades, for which very limited capital is committed. Asset managers, by contrast, serve investors and clients as fiduciaries, on a low-leverage, long term investment basis, and while they have the capacity to provide liquidity, their primary obligation is to serve their clients and investors, making them predominantly liquidity takers. At the same time, each of these non-primary dealer market participants contributes in unique and important ways to the liquidity profile of the U.S. Treasury market.

A wide range of market participants—including bank portfolio and asset managers, fixed income and swaps dealers, bond underwriters, and mortgage bankers and servicers—rely on Treasury securities to actively assume interest-rate risk or to manage the rate risk inherent in their business activities. Each of these participants will have a unique risk profile—by term and duration, scale, and variability. Collectively, they rely on the availability of Treasury securities across an extensive term structure for their investment and hedging needs.

The characteristics of the market also vary significantly across product segments, particularly with respect to the on-the-run and off-the-run segments, with the on-the-runs trading much more frequently and electronically (i.e., typically on many-to-many platforms in both the cash and futures markets).

---

<sup>24</sup> The New York Fed currently recognizes 23 primary dealers. The primary dealers list is available at <https://www.newyorkfed.org/markets/primarydealers>.

Significant differences among market participants may also be seen in their business models, functions, trading practices and strategies. Some factors and forces that have been reshaping the Treasury market have enhanced liquidity and stability, and others have had more negative effects. In addition, the suggestion by some that cash Treasuries trading activity may be shifting toward the futures market, or other markets, increases the importance of understanding the reasons for these changes, and how an appropriate regulatory response could enhance market operations while facilitating greater liquidity.

## **Treasury Market Policy Questions**

### ***Official sector data repository***

SIFMA fully supports increasing official sector (*i.e.*, market and prudential regulators) access to data related to U.S. Treasury market transactions. We strongly believe that the official sector must have access to the data necessary to carry out its various regulatory functions, to develop a more comprehensive understanding of U.S. Treasury market activity and to improve Treasury's ability to oversee market liquidity, resiliency and efficiency. SIFMA has been working with its members as they prepare to begin reporting secondary market Treasury transactions to FINRA through the TRACE reporting engine. We believe once fully implemented this will materially increase the official sector's ability to fulfill its market surveillance duties. To enhance the data available to regulators, consideration should be given to including market participants who are not currently subject to TRACE reporting requirements.

### ***Public dissemination of Treasury transaction data***

With respect to further public dissemination of Treasury secondary market activity, SIFMA's feedback from members indicates that there is an abundance of publicly available information sufficient to allow market participants to obtain information needed to trade in a competitive, fair and efficient manner. Indeed, the unique nature of the Treasury market and the Treasury auction process, with the need for primary dealers to be able to hedge their positions on a confidential basis, counsels extreme caution in moving forward with additional public disclosure.

For the most liquid segment, on-the-run securities, executions and a range of other data are observable by monitoring information available from the primary execution venues for these products. Specifically, we believe there is considerable price transparency in the on-the-run market through trading platforms such as BrokerTec and NASDAQ Fixed Income (previously known as eSpeed) and the futures markets, where indicative bids and offers are available and executable, and, for customers, through direct access to dealer franchises. With respect to less liquid products (*e.g.*, off-the-run securities), indicative pricing and other market data are available from Tradeweb and Bloomberg, and customers also have multiple options for direct access to dealer franchises that can also provide indicative bids for less liquid products.

We do not believe that increased reporting of Treasury transactions to the public would have any net positive effect on improving market functionality or liquidity. Specifically, we believe that there are significant identifiable and predictable risks to market diversity, liquidity and resiliency that arise

from the prospect of mandatory increased public disclosures that outweigh any potential—as yet unidentified—benefits. Two aspects should be considered in this context: (i) large positions/client accommodation, and (ii) primary dealers’ ability to hedge.

We believe that a range of market participants would be inhibited in their investing activity if they deemed the detail and frequency of public data dissemination too high, particularly for the off-the-run market and large trades across market segments (which also require time to hedge). Parts of the Treasury market are very concentrated and transactions occur in large sizes.<sup>25</sup> Third-party investors, particularly those providing the principal-based liquidity that is so critical to this market, have a legitimate and well-established interest in maintaining the confidentiality to be able to trade without concern that too much public information will hurt bilateral price formation.

Similarly, the ability of primary dealers to hedge their positions around Treasury market auctions and in meeting counterparty demand in the secondary market, which is critical for such market participants to continue serving as principal-based liquidity providers for a diverse investor base, would be compromised if they were unable to do so on a confidential basis. Without this ability, it would be materially more difficult for primary dealers to commit significant amounts of capital to satisfy market and client demands, and to meet their obligations set forth by the New York Fed. Given the importance of primary dealers’ role in the auction process, and for maintaining liquidity in the market, SIFMA believes that the prospect of losing confidentiality for these market participants would have serious consequences for their critical role and the market more broadly.

### ***Mandatory Central Clearing***

Additionally, SIFMA supports the further investigation and study, to be led by Treasury, of the potential costs and benefits of implementing a mandatory central clearing requirement for the cash Treasury market, and we believe this study should consider all potential forms of a clearing requirement that could be implemented across the cash Treasuries product ecosystem (*i.e.*, on and off-the run issues, the when-issued market, repos, etc.). We also support further study and evaluation of the costs and benefits of mandatory centralized repo clearing.

### ***Capital and Liquidity***

As noted above, liquidity and capital requirements have had a material impact on banks’ traditional role as primary dealers and their associated market-making function in the Treasury market and their willingness and ability to hold inventory. Specifically, SIFMA believes that the measurable reduction in primary dealer inventory and market-making capacity that is potentially affecting Treasury market liquidity can be tied, at least in part, to banks’ responses to the implementation of new prudential regulations. The new rules increase the amount and quality of capital that banks have to hold and introduce a minimum leverage ratio requirement designed to limit excessive

---

<sup>25</sup> See Joint Staff Report at 52.

leverage in the banking sector.<sup>26</sup> We are supportive of the capital and liquidity regulations that have been put in place since the crisis to improve the safety and soundness of banking institutions. We are concerned, however, that the resulting reduction in primary dealer inventory and market-making capacity being driven by what is, in some cases, non-harmonized capital rules that target the same risk numerous times, may be hampering the ability of other market participants to execute trades, particularly in stressed environments. This is because as the mandate of the franchise business is narrowed by external regulatory requirements, the ability to service customers is constricted.

The requirement for bank-affiliated primary dealers to hold High Quality Liquid Assets (HQLA) illustrates our concern. As banks, such primary dealers are required to hold a buffer of HQLA, *e.g.*, Treasuries, to meet the requirements of the Liquidity Coverage Ratio (LCR) rules. The increased demand for HQLA has decreased their supply (and has decreased the level of inventory that may otherwise be available). Relatedly, higher capital charges on banks for low yielding assets have increased the banks' need to hold higher yielding collateral and decreased their ability to act as dealer or market makers in low yielding assets such as Treasuries. At the same time, the cost of financing capital has increased. Banks traditionally use repo markets to finance trading and market-making activity. Because repos were traditionally assigned low risk weights, since they are normally fully collateralized with high quality collateral, banks only needed to allocate limited capital to repo positions. However, banks now face higher capital charges to account for counterparty credit risk from repo exposures.<sup>27</sup>

As the capital constraints on banking institutions continue to increase due to recent proposed changes to capital and leverage ratio calculations, banks' willingness to engage in such low margin businesses will likely come under increased pressure and their ability to step in and support the market during times of stress will be challenged. The liquidity being provided by PTFs has filled the liquidity void under normal market conditions to some extent, but market depth has become more fleeting in general. Moreover, less diversity in liquidity providers leads to less resiliency, particularly during stress periods.

We believe that a review of the coherence of the current regulatory regime is timely and should include, among other assessments, an evaluation of several issues, including, for example, how the Treasury market is impacted by the LCR. As described above, under the LCR, banks are on one hand forced to hold HQLA, such as Treasuries, and on the other hand they are forced to hold more capital as a result of holding these very same assets. We urge a review and assessment of these concerns by examining duplicative and overly burdensome capital and liquidity regulations on market participants, and determining whether they are having the unintended effect of reducing or weakening market liquidity.

---

<sup>26</sup> PricewaterhouseCoopers LLP, "Global Financial Markets Liquidity Study (Aug. 2015) (GFMA Study) at 36, available at <http://www.pwc.se/sv/pdf-reports/global-financial-markets-liquidity-study.pdf>.

<sup>27</sup> *Id.* at 39.

## Municipal Securities Market Overview

Municipal securities are issued by state and local governments to finance investment in schools, roads, airports, water and sewer systems, and all manner of infrastructure. Approximately 75% of the nation's infrastructure is financed, built and maintained by states and localities, and nearly all of that was financed with municipal bonds.

Municipal securities are unique in several respects. First, unlike stocks and corporate bonds, municipal securities are exempt from registration from the SEC, meaning that municipal bond issuers are not directly required to produce prospectuses for new bond issues or file them with the SEC. Instead, SEC rules require dealers to obtain and distribute official statements (OSs), which are similar to prospectuses in some respects but do not require SEC approval. Also, municipal issuers must produce a new OS for each new bond deal—there is no concept of “shelf registration” in the municipal market. Continuing disclosure for municipal issuers—rules governing the dissemination of disclosure information after bonds have been issued—is also quite different in the municipal market. As the SEC does not have statutory authority to regulate municipal issuer disclosure directly, the disclosure rules in the municipal market are implemented through dealers.

Second, the interest on most municipal securities is exempt from federal and, in many cases, state and local income taxation. This feature significantly reduces borrowing costs for state and local government. However, the tax-exempt nature of municipal interest effectively prevents market participants from “shorting” municipal securities, which is a common hedging strategy across the capital markets. Hedging positions in municipal securities must be accomplished by shorting Treasury securities or using derivative products that are tied to non-municipal securities, like Treasury futures contracts. However, because these hedges may not mirror the underlying long position in the bonds, the hedges are inefficient and may not offer much protection against market losses. The tax-exemption for municipal bond interest, while important for reducing state and local borrowing costs, effectively makes the municipal market a long only market by preventing shorts. This in turn negatively affects market liquidity since dealers often cannot perfectly hedge trading positions.

The use of electronic trading platforms as a price discovery tool<sup>28</sup> has become more prevalent in recent years. Two platforms in particular have established significant footholds in the market, TMC Bonds and Tradeweb Direct. TMC Bonds provides a means for dealers to post executable offerings of bond positions. Buyers can execute trades directly on screen. Participants can see full depth of market with visibility of prices, yields, spreads and sizes of all orders. Users can search and execute orders by CUSIP, direction, price, yield, spread and size with an option to define minimums, increments, and minimum balance remaining. All orders are live and executable. Tradeweb Direct offers a means for users to solicit bids for bonds they may want to sell. The platform supports both dealer-to-dealer and dealer-to-investor (mid-size institutional users). Dealers often use the platform to solicit quotes for their retail customers. A number of other platforms, including electronic interfaces operated by traditional voice brokers' brokers, also offer the ability to discover prices and

---

<sup>28</sup> The MSRB has warned selling dealers that they should not use the bid wanted process for price discovery if they have no intent to sell the bonds, as it harms the integrity of the bid-wanted and offering processes.

execute trades in municipal securities, and the use of electronic trading in the municipal market is likely to grow in the future.

## **Municipal Securities Market Policy Questions**

Several actions by regulators in recent years have threatened to hamper municipal and corporate bond market liquidity. In 2012, the SEC published a comprehensive report on municipal securities market structure and regulation.<sup>29</sup> In the report, which was unanimously endorsed by all SEC commissioners at the time, the SEC discusses two general areas of focus, municipal disclosure regulation and municipal market structure. SEC Chair White accelerated the push for an examination of both the corporate and municipal bond market structure in 2014 with focus on markup disclosure, best execution and increased pre-trade transparency.<sup>30</sup> The best execution rules have been implemented, the markup disclosure rules are pending implementation, and consideration of pre-trade transparency requirements continues.

### ***Markup Disclosure***

Dealers are in favor of disclosure of relevant transaction data to retail investors, as such transparency supports investor trust and confidence in the markets. However, although the markup rule will not take full effect until May 2018, it is already raising concerns among market participants as firms develop the systems needed to implement the new rule. The MSRB and FINRA rule changes will require dealers to begin disclosing the amount of markup and markdown they earn on same-day trades where at least one leg of the trade involves a retail customer. In other words, if a dealer buys a bond from a customer and resells the same bond to another customer on the same day and at least one of those investors is an individual, then beginning in May 2018, the firm must begin reporting the amount of markup/markdown to the retail customer.

Markup and markdown are defined as the difference between the price charged to the customer and the interdealer price for the bond at the time of the customer trade. Determining the markup is easy when a dealer buys and sells a bond simultaneously, sometimes called a “riskless principal” transaction. The markup is simply the difference between the price the dealer bought the bond from another dealer and the price the dealer sold the bond to the customer. However, if some hours have passed between the dealer’s purchase and sale, market prices may have moved. The rules in these cases will require the dealer to calculate the markup based not on their acquisition price but on the “prevailing market price” at the time the dealer sells the position.

Because the vast majority of municipal and corporate bonds trade infrequently, determining the prevailing market price in a moving market when there may not have been many or any recent interdealer transactions in the bond can be difficult. Both the FINRA and MSRB rule specify a prescriptive list and priority of factors that dealers must step through in determining prevailing market price under these circumstances, referred to as a “waterfall.” These factors include the prices of any contemporaneous inter-dealer trades, institutional trades, or quotations. If those factors are

---

<sup>29</sup> Securities and Exchange Commission, “Report on the Municipal Securities Market,” (July 31, 2012).

<sup>30</sup> SEC Chair Mary Jo White, Intermediation in the Modern Securities Markets: Putting Technology and Competition to Work for Investors (June 20, 2014), available at: <http://www.sec.gov/News/Speech/Detail/Speech/1370542122012>

not available, the rules specify additional factors dealers must review to establish prevailing market price, including prices, or yields calculated from prices, of contemporaneous inter-dealer trades in a specifically defined “similar” security, institutional trades, or quotations;

The rule includes some indicators for determining whether another bond is “similar” to the bond in question. If these factors involving “similar” bonds are not available, the MSRB and FINRA rules specify that dealers must use “economic models” to determine prevailing market price, and if that is unreliable, the dealer should look to customer transactions and make “adjustments” to calculate prevailing market price.

As it should appear, the process for determining prevailing market price on days when the market has moved during the time between transactions is complex, nonspecific and subjective. In a market where many bonds trade infrequently, determining the value of a bond at any point in the day can be both art and science. Experienced bond traders are adept at determining bond prices. However, the overly specific nature and order of the steps prescribed in the rules create very significant compliance burdens, given the shift from a historical focus on a range of reasonableness of markups to the accuracy of a very specific data point derived from subjective analysis. Moreover, there are serious questions regarding the kind of documentation firms must maintain to demonstrate that they followed the waterfall precisely in determining prevailing market price. Perhaps most importantly, the prescriptive yet subjective waterfall does not lead itself to automation in an environment that is increasingly adopting electronic trading with less human intervention. Market participants have asked for more flexibility in the implementation standards but there appears to be an unwillingness to better balance multiple objectives while not significantly compromising the objective of increased transparency. Even in light of the recent guidance, we remain concerned about unintended consequences of the rules. For example, if dealers face unmanageable compliance risks and significant implementation costs, they may reduce their market activity in ways that ultimately diminish market liquidity.

### ***Pre-trade Price Transparency***

In its 2012 paper on the municipal securities market, the SEC made two recommendations to enhance “pre-trade” price transparency in the municipal market:<sup>31</sup>

- “The Commission could consider amendments to Regulation ATS to require an alternative trading system (ATS) with material transaction or dollar volume in municipal securities to publicly disseminate its best bid and offer prices and, on a delayed and non-attributable basis, responses to ‘bids wanted’ auctions;” and
- “The MSRB could consider rules requiring a brokers’ broker with material transaction or dollar volume in municipal securities to publicly disseminate the best bid and offer prices on any electronic network it operates and, on a delayed and non-attributable basis, responses to “bids wanted” auctions.”

Both FINRA and the MSRB have been exploring ways to further the development of a pre-trade transparency regime consistent with the above recommendations. SIFMA strongly supports reasonable efforts to improve price transparency in the municipal and corporate securities markets.

---

<sup>31</sup> SEC, pages 143-144.

The dealer community has supported the MSRB's Real-time Trade Reporting System (RTRS), the MSRB's EMMA platform, and FINRA's Trade Reporting and Compliance Engine (TRACE). These are the mechanisms for collecting and accessing trade prices and other trade information, but the MSRB systems also provide for the collection of disclosure information and other related municipal market information and data. We continue to support the ongoing development and operation of these systems through the fees our industry pays. However, we are concerned that a pre-trade price transparency regulatory initiative could be expensive to develop and implement while yielding limited useful information for investors. We believe that regulators need to carefully and thoroughly assess the costs and benefits of any pre-trade transparency proposals.

Part of the SEC's analysis leading to its recommendations was based on an academic study published 11 years ago, using data that is now 17 years old.<sup>32</sup> Policymakers should be cognizant that the transparency of the market has improved significantly since that time from both further development of the post trade reporting regime and forthcoming regulatory requirements on markup disclosure, as well as by market driven efforts.

While we support improvements to market transparency, we urge the SEC, MSRB and FINRA to allow the best execution and markup disclosure rules to take full effect so as to permit additional time to reevaluate the issue of retail price transparency and trade execution. After monitoring the effect of those rules and with the benefit of the additional observations and data, regulators will be better positioned to weigh the cost and benefits of any initiatives while taking into account the cumulative impact of more recent rule changes.

## **Securitization Market Overview**

Securitized products are bonds that are collateralized by cash flows from transactions such as loans or leases. The issuer of a mortgage-backed security ("MBS") or asset-backed security ("ABS") assembles a pool of assets such as mortgage loans and sells securities to investors backed by the cash flows on the underlying assets. When a homeowner whose mortgage has been securitized makes her monthly mortgage payment, the principal and interest she pays is passed through to MBS investors. The securitization markets funded 60% of consumer lending in 2016.<sup>33</sup>

The securitization markets can be generally divided into three distinct but broad markets. The MBS market can be divided into agency and non-agency markets. The agency market is those for MBS issued and/or guaranteed by Fannie Mae, Freddie Mac, or Ginnie Mae. The non-agency market is for MBS issued by private-sector institutions. ABS markets are markets for securitized consumer debt, auto loans and leases, commercial loans and leases, credit cards, and other types of securitizations.

---

<sup>32</sup> Lawrence E. Harris and Michael S. Piwowar, Secondary Trading Costs in the Municipal Bond Market, J.FIN. (June 2006), page 1361.

<sup>33</sup> Federal Reserve Bank of New York, Quarterly Report on Household Debt and Credit, (Feb. 2017).



### *Agency MBS Market*

Agency MBS are MBS issued and/or guaranteed by Fannie Mae, Freddie Mac, or Ginnie Mae. These MBS carry a guaranty of timely payment of principal and interest that is backed by the full faith and credit of the US government in the case of Ginnie Mae, and a significant US Treasury capital commitment in the case of Fannie Mae and Freddie Mac. This means that investors in these markets are not exposed to credit risk – instead, they focus on interest rates and the prepayment risk of the securities. Prepayment risk is the risk that a mortgage borrower will repay some or all of their mortgage before it is due. This can be good or bad for the MBS investor, depending on the price they paid for the bond and the current level of interest rates. Importantly, investors in Agency MBS do not want to be exposed to credit risk – similar to Treasury investors, they are “rates” investors.

The largest portion of the agency MBS market is the “To-Be-Announced” (TBA) market. In a TBA trade, bonds are sold and bought on a forward basis—settlement is typically 30-60 days out from the day of the trade—and the exact identity of securities to be delivered is not known. Securities in the TBA market are subject to “Good Delivery Guidelines” and are considered fungible. Market standards, settlement conventions, and trading practices in the TBA market were developed by market participants under the auspices of SIFMA’s predecessor organization the Public Securities Association, and have been organized and maintained by SIFMA since the early 1980s. There is a separate TBA market for each of Fannie Mae, Freddie Mac, and Ginnie Mae. This may change in 2019 if the Federal Housing Finance Agency (FHFA) and government-sponsored enterprises implement their single-security project, which is designed to merge the Fannie and Freddie TBA markets into one single market.

The TBA markets are very liquid, although less liquid than in prior years. In 2016, an average of \$210 billion of TBA trading took place on a daily basis, second only to US Treasuries, and bid-ask spreads average 4 basis points.<sup>34</sup> It attracts investment capital from around the world – foreign investors provide important funding to US mortgage borrowers. The main benefits of this market are: (1) the ability of lenders to provide 30-60 day rate locks to borrowers at low or no cost since they are able to sell loans on a forward basis, locking in prices, (2) the ability of banks to economically underwrite freely prepayable 30 year mortgages, (3) the ability of lenders and servicers to hedge risk, (4) the ability of investors to access liquid, safe, and long-term investment markets, and (5) lower cost of mortgages due to immense liquidity.

TBA market liquidity has declined somewhat in recent years. Factors driving this include the shrinking of balance sheets by capital-constrained dealers, the low interest rate environment, which has driven investors into other higher-yielding sectors, and a FINRA rule requiring most MBS and ABS trades to be reported in real time to FINRA’s Trade Reporting and Compliance Engine (TRACE), which has made harder for participants to transact in larger blocks of securities. The market share of the top 10 dealers in the TBA market is 81%, according to FINRA data.<sup>35</sup>

There is a significant volume of trading on electronic platforms in the TBA sector particularly among larger dealers. SIFMA members have reported up to 75% or more of TBA trading taking place on an electronic platform. Similarly, some firms have estimated that a significant proportion

---

<sup>34</sup> FINRA, Analysis of Securitized Asset Liquidity, at 12.

<sup>35</sup> Id., at 14.

of dealer to customer trading takes place on platforms, possibly as much as half. This trend may vary by institution.

The vast majority of dealer-to-dealer TBA trading is cleared at the Fixed Income Clearing Corporation (FICC). Clearing and settling trades involves the process of matching trade details between two counterparties and moving securities and cash from one owner to another. A smaller proportion of customer trading is directly cleared through FICC, but many customers clear through an FICC participant so that their trading may be netted and cleared. FICC also operates an electronic pool notification system, which is how the majority of market participants notify one another of the actual pools that will be delivered to fulfill the TBA contract.

### ***Non-TBA Agency MBS***

The other parts of the Agency MBS market are the specified pool and Collateralized Mortgage Obligation (CMO) markets. The specified pool market is where MBS trade on a specified basis and where the specific security to be delivered at settlement is known at the time of trade. CMOs are structured bundles of Agency MBS.

Liquidity in specified pools and CMOs is far lower than in the TBA market. FINRA reports average daily trading volume of approximately \$20 billion and \$3.3 billion, respectively, for specified pools and Agency CMO.<sup>36</sup> There is far less electronic trading in this market than in the TBA market, although some members report increasing electronic trading in specified pools. The market share of the top 10 dealers in the specified pool market is 67%, and in the CMO market 62%, according to FINRA data.<sup>37</sup>

### ***Non-Agency MBS / Private Label MBS***

Non-Agency, or Private Label MBS are MBS issued by private entities such as banks or finance companies. These MBS do not carry a government guarantee, and investors are exposed to both credit risk and prepayment risk. Due to a variety of issues, the non-agency MBS markets have seen very low issuance of securities backed by new mortgage loans since 2007. In 2005-2006, these MBS represented almost half of total MBS issuance, whereas today they represent less than 5% of MBS issued. Today's non-agency MBS new issuance market is defined by securitizations of reperforming loans, defaulted loans, and loans that were originated a number of years ago.

Non-agency mortgage securities markets are far less liquid than TBA. The average age of a non-agency MBS that traded in 2016 was over 10 years,<sup>38</sup> which is indicative of the lack of new issuance, and average daily trading volumes are just under \$3 billion.<sup>39</sup> The market share of the top 10 dealers in the non-agency MBS market is 67%, according to FINRA data.<sup>40</sup>

---

<sup>36</sup> Id., at 9.

<sup>37</sup> Id., at 14.

<sup>38</sup> Id., at 6.

<sup>39</sup> Id., at 9.

<sup>40</sup> Id., at 14.

### ***Asset-backed securities***

A broad range of cash flowing instruments are securitized in the ABS markets. They range from credit cards and auto loans to trade receivables to equipment loans and leases to the cash flows from entire businesses (i.e. whole business securitization, used by franchises such as Dunkin Donuts and Wendy's). The most liquid sectors are those for debt issued by large, regular issuers of credit card and auto loan debt (e.g., Capital One, Ford Motor Credit), where bid-ask spreads averaged 4 basis points in 2016.<sup>41</sup> All together, about \$2 billion of ABS trade on a daily basis.<sup>42</sup> The market share of the top 10 dealers in the mainstream ABS sectors (credit cards, auto loan/lease, and student loans) ranges from 83-84%. Other types of ABS see a top 10 share of 74%.<sup>43</sup>

### **Securitization Market Policy Questions**

It has been estimated that had the capital requirements for securitization been rationalized, the complexity of disclosure been limited to what was reasonable, and other related securitization and lending regulations been similarly tailored, approximately \$1 trillion of additional residential mortgage loans would have been made over the last five years, resulting in 0.5% higher GDP growth in each of those years.<sup>44</sup>

Capital requirements are increasingly risk-insensitive while both capital and liquidity requirements are excessively conservative and do not adequately consider the effects on financial market activity. There are a number of flaws in the capital and liquidity rules covering securitization, the overall effect of which has been to diminish the participation by banking institutions in the securitization process both as investors and as originators, thereby decreasing the availability of funding to the real economy. These include the CCAR rules for calculating capital to address defined shocks to the system for securitizations are excessive and should be revised for securitization positions. In addition, the recent Basel III revisions to securitization capital requirements that have not yet been applied to the risk-based capital requirements in the United States, should not be adopted, or, if they are adopted, their deficiencies should be addressed so that in either case the U.S. risk-based capital requirements for both the banking book and trading book are more rational.

Under the rules as now written, required capital may exceed the maximum possible loss on the position, i.e., a total write-off. GSE MBS and asset-backed securities should receive more equitable treatment under the LCR. If capital requirements were rebalanced, and securitization's liquidity characteristics more sensibly recognized, growth and employment would follow without any material diminution in safety or liquidity.

---

<sup>41</sup> Id., at 12.

<sup>42</sup> Id., at 9.

<sup>43</sup> Id., at 14.

<sup>44</sup> Letter from Jamie Dimon, Chair of the Board and CEO, JP Morgan Chase, to shareholders, April 4, 2017.

### ***Regulation AB II***

Regulation AB II is overly burdensome and has effectively shut down registered markets for non-agency residential mortgage-backed securities and has significantly curtailed registered issuance for smaller or more infrequent asset-backed securities issuers. While private offerings—unregistered, often relying upon Rule 144A—remain viable, they face the risk of proposed similar regulation and, by definition, are constrained sources of capital and funding since the investor base is far smaller than that for registered transactions. This regulation has effectively constrained real economy activity that public offerings of securitization transactions could more efficiently fund.

### ***Credit Risk Retention Rules***

The credit risk retention rules are very lengthy, detailed, and complex yet fail to adequately reflect important characteristics of the different kinds of securitization transactions that finance distinct asset classes, such as mortgage loans, auto loans, and commercial loans. In some cases, the rules require an excessive amount of risk retention by failing to make any adjustment for the related funding and non-credit risks, for example, market and interest rate risk, or to give appropriate credit for other forms of risk retention. The rules are overly prescriptive regarding the manner in which the required retention must be held and for many asset classes require that the retention be held well beyond the period in which weak underwriting, or other similar moral hazard, would be expected to become evident.

### ***Margin Requirements for Uncleared Swaps***

Many securitization transactions employ swaps to match or hedge the cash flows that arise from the assets that collateralize the transaction to those which are required to be paid to investors in the liabilities issued by the transaction. These regulations fail to reflect the fact that special purpose entities are different from typical counterparties on flow-traded swaps. Special purpose entities are not operating companies, and they contain special structural features designed to mitigate counterparty risk. As a practical matter, special purpose entities will find it difficult if not impossible to comply with the margin and clearing requirements as implemented and will either have to forego derivatives and their risk mitigating benefits or find a way to comply which will not be efficient for the transaction. Either way, the rules will have a harmful effect on the cost and availability of securitization as a financing tool hindering the vibrancy of the financial markets.

### ***Qualified Mortgage Standards***

While the CFPB published the lengthy and detailed QM rules and their Appendix Q in an effort to provide guidance to lenders on how to underwrite loans in compliance with the law, the practical impact has been that the requirements are complex, inflexible and fail to properly take into account differing circumstances of particular types of borrowers. At the same time, despite their complexity, the rules and their appendix lack important clarity on critical aspects of the lending process. For example, how a lender may rely on borrower bank statements or document the income of self-employed borrowers remains unclear years after the rules were enacted. Lenders, securitizers and investors have found it difficult to obtain written guidance on these and similar issues upon which they can be comfortable relying.

### ***Volcker Rule Impact on Securitization***

The agencies responsible for implementing the Volcker Rule created an overly inclusive definition of covered fund that subjects many securitization entities to the Volcker Rule's restrictions, even though they are clearly not private equity or hedge funds. The compliance burden for banking organizations that hold or trade securitization transactions is significant, with no or few corresponding benefits. We believe the Volcker Rule's definition of covered fund should be narrowed to ensure that only those investments (particularly in hedge funds and private equity funds) intended by Congress to be captured are captured.

### ***TILA-RESPA Integrated Disclosure Rule (TRID)***

TRID is the CFPB's rule which combines the previously separate TILA and RESPA disclosure forms. It is very detailed and prescriptive, yet unclear. Lingering misperceptions and technical ambiguities in the regulations have resulted in significant market disruptions. Many market participants are reporting very high TRID fail rates on closed loans delivered for sale. Moody's recently reported that approximately 90% of one sample of loans did not fully comply with TRID requirements.<sup>45</sup> If these conditions persist, many lenders will experience liquidity issues as unsold or repurchased loans clog warehouse funding lines and balance sheets. Further, although some lenders may have multiple investor options, investors often have different standard for TRID compliance. As a result, originators are not always able to deliver loans to the investor with the best price, and hence the best rate for the consumer, and instead must deliver based on investors' TRID interpretations. For consumers, these dynamics will increase both the costs of origination and the interest rates they pay.

### **Conclusion**

Traditional bank lending often receives considerable consideration by policymakers, much of it appropriate. But to exclusively focus on those policy questions ignores the more significant source of financing that drives our economy---our capital markets. Bonds finance everything from home mortgages and car loans to highways and schools to factories and equipment as well as the very federal government itself. The bond markets set interest rates for commercial and consumer lending and provide a safe and predictable investment for millions of Americans.

While the fixed income markets are fundamentally healthy today, there are significant uncertainties about whether our economy is operating at full efficiency. Most important, a plethora of financial regulations has been adopted since the crisis and the cumulative effects have not been measured or analyzed sufficiently. In the fixed income markets, liquidity depends on the ability and willingness of dealers to commit capital to market making. Accordingly, policymakers need to calibrate existing and future rules to ensure they do not unduly impede the ability of the market to provide the capital needed to finance strong growth in the economy.

---

<sup>45</sup> Moody's Investor Service, U.S. Mortgage Lenders Face Difficulties Complying with New Rules, a Credit Negative for RMBS, December 10, 2015.

We appreciate the opportunity to present our views and we look forward to working with the Congress, the Administration, and the independent agencies and regulators to help ensure that the bonds markets continue to perform their vital functions and operate safely and efficiently to move America forward.