Examining the Corporate Bond Block Trade Reporting Pilot

June 4, 2019

Following recommendations from the SEC's Fixed Income Market Structure Committee (FIMSAC), FINRA is proposing a pilot program to test the impact of changing the reporting requirements for large corporate bond trades. Pilot programs can be good. Most market participants test out new products and ideas before fully rolling them out, and the government should too. And as an analyst, I can't get enough of research backed by good data.

That said, pilot programs do cost the industry time and money, so making sure the proposed change could result in the desired impact beforehand is critical. The bond market should do everything it can to avoid the debacle that was the tick size pilot in the U.S. equity market, which ultimately cost the industry hundreds of millions of dollars with no particularly notable findings. Ensuring that what is proposed passes the sniff test is a good first step in that direction.

If you're reading this you likely already know the details of what's proposed, but here's a recap including our translation of the SEC's language:

Size Cap

SEC: *"It would increase the current dissemination caps from $5 million to $10 million for IG corporate bonds, and from $1 million to $5 million for non-IG corporate bonds. This would result in the dissemination of additional size information for trades between the current and proposed caps."*

Greenwich Associates: Trades larger than the current reporting caps, no matter how much larger, are reported as the cap size with an appended "+". So a $50 million investment grade bond traded would get reported as $5mm+. This proposal would raise those caps, which in theory would mean the market would see more information on larger orders.

Reporting Delay

SEC: *"The pilot would delay dissemination of any information about trades above the proposed $10 and $5 million caps for at least 48 hours."*

Greenwich Associates: Any trades larger than the reporting caps would not be reported for 2 days, compared to 15 minutes today. This, in theory, gives market participants additional time to either hedge their new position, or work out of it, without the market moving against them.

Putting these two proposed changes together, in theory, represents a compromise. The size cap change adds more transparency to the market, whereas the reporting delay reduces transparency but in theory improves liquidity if dealers are willing to take more principal risk given the additional time provided to manage that risk.

Increasing the size cap is not terribly controversial. The majority of banks and investors we've spoken with over the past few weeks believe this extra level of transparency makes sense in today's market. More informed liquidity makers and takers, broadly speaking, results in a better functioning market.

To put the value of this extra data in perspective, on March 15, 2019 (a somewhat random day we chose as an example) 1,118 trades out of 63,895 trades were reported as $5m+ - 1.7% of the total. But those trades accounted for $13.1 billion out of $36.6 billion – nearly 36% of the total market that day. This can also be translated as $13.1 billion in trades done for which the market doesn't have the whole story. I do believe there is a thing as too much transparency, but this change seems like a reasonable step forward.

The reporting delay is quite a bit more controversial but does have its merits. Bond dealers have limited capital to hold bond positions acquired via facilitation of a client trade, and cannot hold positions too long at the risk of violating Volcker Rule proprietary trading limitations. As such, they look to buy only bonds that can either be quickly hedged or quickly sold to another customer. This is another way of saying principal liquidity provision has been reduced.

So as the thinking goes, if only the two counterparties to a block trade know about the trade for two days, the dealer involved will have more time to hedge or sell, making them more willing to do those block trades in the first place. Translation: more principal liquidity.

For dealers executing a lot of big blocks and the large asset managers on the other end, this is a no brainer. But for everyone else, many of whom may already feel like they're at an information disadvantage, the expected increase in dealer liquidity will have a smaller positive impact on them then the reduction in transparency's negative impact. Conversely, an argument can be made that smaller investors could see less price gapping if aggressive market reactions to reported big block trades decline – but that is something we need the pilot to confirm.

The reduced transparency intraday could also have some other knock-on effects. One could debate the validity of index calculations (for ETFs and CDS, for example) and mutual fund NAVs given the potential that a big trade or trades isn't accounted for when end of day bond prices are set. And another interesting concern: after a dealer has done a block trade with delayed reporting for client A, can they tell client B? Or are they obligated to tell client B?

Ultimately, we think most market participants would rather see principal liquidity increased by changing the capital and proprietary trading rules that caused the decline in principal liquidity in the first place. But despite some movement on both in Washington, that remains a tall order. Electronic trading venues have accepted the challenge of increasing block trading head-on, having had some success evidenced by higher average trade sizes done on screen, but there is a long way to go. It also seems like that existing "compromise" needs to see further compromise. Potentially reducing the reporting delay from 48 hours to 24 hours or 2 hours.

Nevertheless, conducting a pilot to test the validity of these and other assumptions is a good idea. However, to avoid the tick size pilot debacle, this pilot must be constructed to limit the required spending by market participants to comply, ensure the data collected will actually provide some concrete evidence for the right path forward, and not adversely impact the bond issuers who are the fuel for the market in the first place.
