

June 5, 2019

Ms. Marcia E. Asquith  
Office of the Corporate Secretary  
FINRA  
1735 K Street, NW  
Washington, DC 20006-1506

**Re: FINRA Regulatory Notice 19-12: Proposed Pilot Program to Study Recommended Changes to Corporate Bond Block Trade Dissemination**

Dear Ms. Asquith,

I appreciate the opportunity to submit a comment letter regarding FINRA's proposed pilot program on corporate bond block trade dissemination.

FINRA's proposed pilot program contains the following key elements:

- Three test groups and a control group  
For Test Group 1, TRACE would apply a 48-hour dissemination delay to trades above \$5 million in IG corporate bonds and trades above \$1 million in non-IG corporate bonds.  
For Test Group 2, TRACE would increase dissemination caps to \$10 million for IG bonds and \$5 million for non-IG bonds, without the 48-hour delay.  
For Test Group 3, TRACE would both increase the dissemination cap (\$10 million for IG and \$5 million for non-IG) and apply the 48-hour delay.  
For the Control Group, there would be no change in TRACE dissemination.
- Bonds entering the pilot study are selected by stratified sampling by issue size, age, rating, and 144A status. Then they are randomly assigned to one of the test groups or the control group.
- Halfway through the pilot, bonds that start in the control group rotate into one of the test groups, and bonds start in the test groups rotate to the control group.

I find FINRA's proposed pilot design and the discussions of the key economic issues to be thoughtful and comprehensive. In particular, FINRA's design carefully isolates the transparency-reducing element of delayed reporting and the transparency-enhancing element of raised dissemination caps. As I elaborate below, I believe there is merit in the recalibration of dissemination caps, but the delayed dissemination of block trades is unwarranted.

**Comments on Delayed Dissemination of Block Trades**

In my view, there is no need to conduct a pilot study on delayed dissemination of block trades. The predominant conclusion from academic research on the TRACE implementation in

corporate bond market is that post-trade transparency provides investors with valuable price information and reduces transaction costs.<sup>1</sup> FINRA's proposal has also extensively discussed the evidence. A dissemination delay would reverse the positive market development brought by TRACE since 2002.

The harmful impact of dissemination delays will also be felt in related securities and markets. If a trade in a liquid, large bond issue were delayed, investors would not be able use its transaction price to infer the market values of other less liquid and yet closely related corporate bonds. This negative spill-over effect also harms the price informativeness of bond ETFs, whose prices depend on the no-arbitrage pricing relationship of the ETF and the underlying basket of bonds. The functioning of credit derivatives markets would also be negatively affected because the prices of IG and HY CDS indices are closely linked to the credit spreads of the constituents of the indices. In a highly interconnected financial system, price information is a public good. Suppressing it has negative impacts that reach far beyond market boundaries.

Delayed dissemination of trades may also lead to legal and systemic risks in times of stress and uncertainty. Suppose, hypothetically, an issuer faces imminent default, but only market participants close to the firm are informed of this likely event. The transaction prices between those sophisticated investors on the firm's bonds will reflect the imminent default risk. But if TRACE delays the dissemination of price information, smaller and less sophisticated investors may end up paying for the bonds at higher prices, which they would not pay if TRACE had reported the transaction prices in real time. In this case, those small and less sophisticated investors are materially harmed by the delayed transaction reporting and may rightly resort to legal actions against FINRA. Worse still, if the defaulter in this hypothetical scenario is a systemically important financial institution, suppressing transaction prices of its bonds could even increase systemic risk.

### **Comments on the Recalibration of Dissemination Caps**

There are potential benefits of recalibrating the TRACE dissemination caps, and a pilot could be helpful here. According to Table 3 of FINRA's proposal document, during 2018, the \$5 million cap applies to 3.1% of IG trades and 56.2% of IG par value traded. For non-IG bonds, the \$1 million cap applies to 18.3% of trades and 85.4% of par value traded. These numbers suggest a highly right-skewed distribution of trade sizes. The dissemination caps are designed to protect dealers and large institutional investors from risks associated with revealing the true size of the trade, such as the risk of predatory trading, especially when market liquidity is low. The IG statistics above suggest that the cap of \$5 million may be too *high* because only 3.1% of the trades benefit from such protection.

I suggest that FINRA includes a *reduction* of dissemination caps in the pilot to address the spirit, if not the letter, of FIMSAC's original recommendation. If the concern is insufficient block

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<sup>1</sup> [Bessembinder, Maxwell, and Venkataraman \(2006\)](#), [Edwards, Harris, and Piwowar \(2007\)](#), and [Goldstein, Hotchkiss, and Sirri \(2007\)](#) all show that the introduction of TRACE reduced transaction costs. [Asquith, Covert, and Pathak \(2013\)](#) find that TRACE reduced price dispersion but also reduced trading volume for certain categories of bonds. If lower transaction volume reflects reduced trading opportunities, it is a negative outcome, but if lower transaction volume reflects faster and more efficient allocation of bonds among investors, it is a positive outcome.

liquidity, a reduction in the dissemination caps allows more block trades to be protected from the risk of predatory trading.

In particular, FINRA could create a few “tiers” at easy-to-use round numbers. For example, IG bonds entering the pilot may be randomly divided into four tiers with various caps: \$0.25 million, \$1 million, \$5 million (control group), and \$10 million (FINRA’s current proposal). The smaller is the dissemination cap, the more difficult it is for “predators” to identify a very large transaction, and the lower is the risk of predatory trading. Under a sufficiently small dissemination cap, almost all institutional trades would be capped in reported size, and there would be little risk of predatory trading. We expect the best design to lie between the two extremes: capping all trades and capping only the very largest trades. With enough data and econometric power, the pilot would identify which of the size caps delivers the “best” outcomes, under metrics that are deemed appropriate.

When measuring the market quality, price-based metrics are typically cleaner to interpret than volume-based metrics. A reduction in transaction costs is a positive outcome for investors; it is hard to argue otherwise. A reduction in trading volume could be interpreted as loss trading opportunities (negative) or a more efficient allocation of bonds among investors to start with (positive). Volume-based metrics are further confounded by the level of interest rates and new issuance. While lost trading opportunities are difficult to identify in transaction data, it is possible to assess their impact using a theoretical model, if the model’s predictions on observable outcomes are supported by the data.<sup>2</sup>

In addition to the market quality measures discussed in FINRA’s proposal, it is also important to examine the distributional effect of the pilot. Which market participants are better off or worse off following an increase (or reduction) in post-trade transparency? Close monitor of behavior also reduces incentives of “gaming” the pilot.

On other aspects of the pilot design:

- By its nature, a pilot should be focused in terms of scope. A stratified sample of corporate bonds seems to strike the best balance between statistical power and costs of implementation.
- There should be a control group of bonds, as FINRA proposes.
- To avoid confusion and second-guessing, the CUSIPs used in the pilot, as well as their group assignments, should be disclosed publicly. For sharper identification, the announcement date and the implementation date should be close to each other.
- Rotating the bonds between control and treatment groups is non-standard and may obscure the interpretation of the results around the rotation date. If a rotation must be introduced for fairness, I would recommend putting a time lag between the first half of pilot (pre-rotation) and the second half (post-rotation) to reduce contamination.

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<sup>2</sup> See [Saar, Sun, Yang, and Zhu \(2019\)](#) for a model that takes into account the cost of lost trading opportunities. They use this model to assess the impact of post-crisis bank regulation on bond market liquidity.

## Conclusion

The spirit of FIMSAC's original recommendation is to improve block liquidity in corporate bond markets. It is a valid concern that disclosing "too much" information about a block trade increases dealers' inventory risk and, in turn, reduces block liquidity that is much needed by institutional investors. But a block trade is defined by its size, not its price. TRACE already puts a cap on the reported trade size to mitigate such risks. To the extent that the current dissemination caps are not effective enough, a recalibration of the caps may well be warranted through a pilot study. Delayed reporting of large trades, on the other hand, undermines the very foundation of post-trade transparency and is a cure worse than the disease.

Sincerely,

A handwritten signature in black ink, appearing to read "Haoxiang Zhu". The signature is fluid and cursive, with the first name "Haoxiang" and the last name "Zhu" clearly distinguishable.

Haoxiang Zhu  
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Faculty Research Fellow, National Bureau of Economic Research