| asset management group

May 19, 2015

Via Email

The Honorable Mary Jo White
Chair
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Potential Market and Regulatory Changes to Strengthen Liquidity in the Fixed Income Markets

Dear Chair White:

As Commissioners Gallagher, Piwowar, and others have noted in numerous speeches and other public forums, the markets have changed since the financial crisis. Under the new regulatory framework, there have been periods of increased market volatility, as well as a concern regarding a potential decrease in the liquidity of some fixed income markets. Market participants may be required to evolve and adapt their businesses to address these potential changes.

The Asset Management Group of the Securities Industry and Financial Markets Association ("the AMG") appreciates the Securities and Exchange Commission's ("SEC") focus on these issues, and in an effort to assist the SEC in its quest to strengthen the markets, the AMG has formed a Liquidity Working Group (the "Working Group"). The Working Group's mission is to develop and implement market and regulatory proposals to address potential changes in liquidity in the most foundational markets, such as investment grade credit and municipal bonds.

Consistent with the SEC's mission to facilitate capital formation, the Working Group strongly believes that barriers to entry, structural or legal disincentives to invest, and outdated regulatory requirements should all be continually examined and re-examined to determine whether they help or hinder that objective. The Working Group notes that investors – particularly institutional investors – have a wide variety of investment options. The US market must provide a robust environment for issuers and investors to find common ground – we cannot afford to presume that will always be the case or that both issuers and investors do not have other options.

In this letter, the Working Group provides a high level overview of the current fixed income markets, and notes some of the current regulatory issues that could impair market liquidity. The

Working Group also outlines several suggestions that we believe would be a helpful starting point for market participant and regulator discussions regarding improving the financial markets and increasing market liquidity.

Given that each suggestion is merely a starting point, the Working Group requests that the SEC consider forming an SEC Advisory Committee to focus on liquidity. If an Advisory Committee is formed, AMG members would be happy to participate and further partner with the SEC in its work to address these concerns. The Working Group believes that an Advisory Committee could be helpful to the SEC not only as it considers suggestions like those presented in this letter, but also as it proceeds on current regulatory initiatives that are reportedly underway, such as considering whether to further define “liquidity.”

It is important to note that the Working Group believes that regulatory intervention is not necessary to address liquidity. Rather, SEC intervention could be most helpful in areas where regulations could be modified, streamlined and/or simplified, facilitating a more robust, liquid market. Many of the initiatives currently underway to facilitate liquidity, such as investment in all-to-all trading venues, may be monitored and considered by the SEC, perhaps through the Advisory Committee, but should otherwise develop organically in the marketplace. Further, it is also important to note that the Working Group believes each change suggested in this letter to facilitate liquidity in the end will only be incremental, and implementing real changes will take time and patience.

I. BRIEF OVERVIEW OF THE CURRENT STATE OF THE FIXED INCOME MARKETS

In the last few years (even prior to the financial crisis), the fixed income markets have been changing for a multitude of reasons. Since the crisis, much of the markets’ evolution has been caused by increased regulatory oversight and requirements, which have increased capital costs and restrictions on banking institutions that previously held significant corporate bond inventories. As noted by Commissioner Gallagher, “inventories are down over 75% since the pre-crisis period.”[1]

The risk appetite of market intermediaries may have also declined in some markets due to market participants taking the time to adjust to and comply with the new regulatory requirements. In some cases, the markets’ evolution seems to simply have led market participants to shift their businesses and deploy resources elsewhere. It appears that banks’ desire to increase their return on equity and make more efficient use of capital has increased the cost and time of sourcing liquidity, which will ultimately lead to increased costs passed on to investors.

[1] *A Watched Pot Never Boils: The Need for SEC Supervision of Fixed Income Liquidity, Market Structure, and Pension Accounting,* U.S. SECURITIES AND EXCHANGE COMMISSION (Mar. 10, 2015), http://www.sec.gov/news/speech/031015-spch-cdmg.html.

However, despite some market participants reducing their balance sheets, the investment-grade credit market has grown significantly since the financial crisis. Since 2007, the par amount of outstanding investment-grade corporate bonds has grown from $5 trillion to over $8 trillion. This growth may be attributable to banks raising capital, and companies' reduction of their use of commercial paper by terming out debt obligations. Much of the growth is also likely due to meeting the needs of a growing economy.

Going forward, the Working Group anticipates that the market will need to continue to evolve and adjust to address the changing liquidity landscape. Additional rulemakings anticipated over the following year, such as stress testing requirements on investment funds, may further challenge the market, if funds are forced to further amend investing strategies and they become more homogenous. Commissioner Gallagher has also noted that interest rate hikes could cause investors to change their investing strategies, exiting positions in high yielding and less liquid debt. The Working Group believes it is important to ensure that investors will not have difficulty in doing so, if or when their clients give the order.[2]

II. SIFMA AMG's Regulatory Proposals

1. Engaging with the Prudential Regulators on Bank Capital Requirements

While regulations are clearly not the only cause of liquidity shifts in the marketplace, many of the bank capital rules have had a direct impact on liquidity. For example, the new stress testing requirements on banks constrain capital and therefore limit banks' ability to sizably increase risk or leverage intra-period. The supplementary leverage ratio ("SLR"), liquidity coverage ratio ("LCR"), and net stable funding ratio ("NFSR") rulemakings, among others, may also add costs and tie up capital. Further, for those banks that have been designated as global systemically important financial institutions, there are additional capital charges and requirements that have negatively impacted liquidity.

It would be helpful to the market if the SEC, as primary regulator of investment funds and other market participants, would further engage with the prudential regulators through multi-agency groups like the Financial Stability Oversight Council ("FSOC") to discuss the consequences of many of the banking capital and regulatory requirements. In particular, the Working Group urges the SEC to focus on addressing the potential cumulative costs and benefits of the regulations, and the effects of the regulation on the greater financial system.

Specifically, the Working Group asks that the SEC consider engaging on rulemakings that have not yet been issued and/or finalized. For example, the prudential regulators are just starting the task of implementing the global standards under NSFR. There are measures the prudential regulators could take to maximize the benefits of the rulemaking, while minimizing the potential

[2] *Id.*

liquidity effects the rule could have on the marketplace. The rule is intended to ensure that banks have adequate funding to survive a time of financial stress. However, the rule's formulaic approach requires banks to hold long-term funding against hedging or client transactions with little or no maturity mismatch, which can be problematic for key markets where banks facilitate client activity for transactions. The AMG is reaching out to the prudential regulators to discuss the buy-side's concerns with the rulemaking; however, the Working Group believes that it would be helpful for the SEC to discuss capital formation issues and balance sheet requirements with the regulators as well.

2. Block Trading Reporting Requirements

The SEC should also work with FINRA and reevaluate the reporting requirements for certain block trades. Although there is a prohibition against front running of block transactions, market participants still could reverse engineer the trades in order to benefit from market movements caused by cover trades. While the buy-side is a strong proponent of market transparency, we do not believe it should come at the cost of decreased liquidity and higher costs, such as wider bid-offer spreads. Transparency would still be accomplished if the trade were reported on a more delayed schedule. The additional time would also make it possible for more trades to occur, thereby increasing market liquidity.

3. Simplifying and Streamlining Regulations

The SEC could positively affect capital formation and market liquidity by making regulatory changes that would significantly reduce costs and increase clarity for asset managers and end-users. For example, the SEC could address standardized documentation, making it more efficient and less expensive to bring standard debt deals to the market. Reducing this burden and the associated cost of accessing capital would correspondingly reduce artificial barriers to entry for issuers.

The SEC could also clarify and streamline areas where there is regulatory uncertainty, which would reduce the costs and regulatory risks incurred by asset managers when engaging in various strategies for their clients. For example, the SEC's implementation of Reg D and the JOBS Act, while helpful in concept, in practice has created additional regulatory uncertainty and burden. There is a role for private placements in the financial system and, with appropriate protections, it can be a source of strong and steady investable assets and augment market liquidity. The possibility of broader based crowd funding platforms ought to be encouraged and facilitated, particularly as some of those structures have the ability to bring in new investors that would not have participated otherwise. By eliminating regulatory uncertainty and focusing on streamlining the registration process, asset managers would be more willing and able to create vehicles and investment opportunities and clients will be more willing to consider investments.

Security characteristics could also be streamlined and standardized, thereby significantly reducing the manpower and costs associated with trading. Today, each bond carries 30-60 attributes, and each asset manager must spend resources to fill in the data. For example, asset managers must determine which bonds the issuers are making ineligible for ERISA investors. If the industry were able to rely on a standard template produced by each issuer when they brought a deal to market, it would make it significantly easier to trade. The Working Group believes this could best be achieved through an industry-SEC partnership, perhaps under the Liquidity Advisory Committee the Working Group suggests above, whereby an agreed-upon set of best practices could be developed and utilized by the industry.

The Working Group encourages the SEC to also re-visit restrictions around which investors are permitted to invest in certain instruments. There is a bewildering maze of ways to define an institutional investor - some of which also comes from CFTC regulation – but the complexity of the definitions is an impediment, and the restrictions shrink the available investor base. For example, institutional clients or new funds may not be able to purchase Rule 144A securities because they do not yet have sufficient assets to be a Qualified Institutional Buyer. To say that an institutional client with $50m+ in investible assets is not sufficiently "institutional" enough for an investment adviser to purchase a Rule 144A security on their behalf is an impediment to liquidity – particularly as the Rule 144A market is materially larger and much more liquid than when the definitions and rules were adopted.

III. INDUSTRY INITIATIVES

Other proposals under consideration by market participants, while helpful at increasing market liquidity, are better left to the market to develop and implement. For example, there has been a great deal of interest in updating the means by which corporate bond trading is conducted through the use of technology and the development of electronic trading ("e-trading") venues. These changes are positive, because they create market efficiency and improve dealer economics.

Similarly, "all-to-all" trading venues allow multiple parties from the buy-side and the sell-side to come together and communicate, providing opportunities to uncover latent liquidity. The Working Group believes that increasing the use of "all-to-all" venues, including exchanges, clearinghouses, and electronic communication networks ("ECNs"), would enhance liquidity by enabling greater market connectivity and centralization of liquidity than the current bi-lateral framework.

However, while these initiatives are positive, the market needs time to develop. In order for e-trading protocols to make any kind of significant difference, more of the buy-side will need to participate and embrace the new protocols. New protocols will also need to be developed that straddle the request-for-quote ("RFQ") and central limit order book ("CLOB") divide. If these protocols were developed and widely adopted, they could potentially alleviate some of the dependency on dealer capital, by bringing latent liquidity to the market. Examples of such protocols would include all-to-all RFQ systems, open trading systems, session-based protocols, and crossing systems.

All-to-all trading venues already exist, but see limited trading activity. Trading activity on these venues may increase if there is a way to increase trade matching, and transparency into the interdealer market. Concerns related to the real-time reporting requirements of block trades also need to be addressed, so that market participants have the confidence to know that they can continue to buy and sell large blocks without causing large price movements.

If the SEC wishes to assist these efforts, the Working Group suggests that it might be prudent for the SEC, after establishing a Liquidity Advisory Committee, to task the Advisory Committee with performing a similar evaluation to determine whether more can be done to encourage fixed income trading platforms and ensure the regulatory framework appropriately balances the various policy objectives. As part of this process, the group could consider whether there are SEC regulations that are unnecessarily impeding the development of these venues. As bank market making activity and inventories shrink, the assumptions and presumptions about market structure are being challenged by the private sector. It would be helpful for the SEC to similarly challenge its own understanding, and therefore its regulatory framework.

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The AMG and its Working Group welcomes the opportunity to work with the SEC to make the markets safer and more resilient for all investors. Going forward, we believe liquidity will remain an important focus for the industry, which the members of the AMG Working Group will continue to monitor and discuss. The AMG looks forward to discussing the aforementioned proposals, as well as other thoughts, with the SEC in coming days. Please feel free to contact Tim Cameron at (202) 962-7447 or Lindsey Keljo at (202) 962-7312.

Sincerely,

Timothy W. Cameron, Esq.
Asset Management Group – Head
Securities Industry and Financial Markets Association

cc: Hon. Daniel M. Gallagher, Commissioner
Hon. Kara M. Stein, Commissioner
Hon. Michael S. Piwowar, Commissioner
Hon. Luis A. Aguilar, Commissioner