SIFMA response to IOSCO's Discussion Paper: Corporate Bond Markets – Drivers of Liquidity During COVID-19 Induced Market Stresses

The Asset Management Group of the Securities Industry and Financial Markets Association ("**SIFMA AMG**") brings the asset management community together to provide views on U.S. and global policy and to create industry best practices. SIFMA AMG's members represent U.S. and global asset management firms whose combined assets under management exceed $45 trillion. The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds. For more information, visit https://www.sifma.org/committees/amg/.

Our members include market participants in the corporate bond market, and we welcome the opportunity to provide feedback on IOSCO's discussion paper on this topic.

General comments on the context of the Discussion Paper

The global corporate bond market is estimated to be worth approximately $130trn and comprises around a third of the total world marketplace in fixed income securities. Its economic contribution to employment, growth and real incomes is significant.

In the U.S., the corporate bond market grew from $11.1 trillion in 2010 to $16.2 trillion in 2020 and the amount of corporate bonds held by registered investment companies rose from $1.5 trillion to $3.5 trillion – or from 14 percent in 2010 to 22 percent in 2020[1]. Investors buy corporate bonds for various reasons: attractive and predictable returns, dependable income, flexibility, and diversification.

We broadly agree with IOSCO's view that '*corporate bond markets are an important part of the global capital markets and play a key role in financing the real economy*' and that achieving '*fair, efficient and transparent functioning of these markets' and 'reducing systemic risk*' are sensible goals. In terms of exploring '*possible ways to help improve market functioning and liquidity provision*' it is vital any proposals – *if* they are forthcoming - are developed carefully and consultatively. In particular, IOSCO notes '*the potential unintended consequences from any prospective market changes*' and such effects would be critical to have identified and evaluated.

In this context, we also ask IOSCO to recognize the significant volume of regulatory and related proposals that the global asset management industry is presently processing. In the United States, the Securities and Exchange Commission ("**SEC**") is pursing what Bloomberg described as "*one of the most ambitious agendas in the SEC's 87-year history*". In the UK, the post-Brexit environment underpins a robust and extensive financial services agenda which includes potential changes to the UK regime derived from the Markets in Financial Instruments Directive ("**MiFID**") which primarily governs secondary bond trading. In the EU, there are significant regulatory initiatives in development, including amendments to the EU's MiFID regime. Everywhere, regulators and policymakers are re-calibrating laws and regulatory rulebooks as climate changes and sustainable growth have moved center-stage.

Moreover, just as the world is coming out of a once in 100-year pandemic, still uncertain what the "new normal" will be, we are now facing considerable economic headwinds. Inflation has climbed to a 40-year high. Interest rates are rising. Geopolitical events threaten to upend how the global

[1] https://www.ici.org/viewpoints/21_view_covid3

economy has functioned for decades. Supply chain disruptions persist. Bottom line: while the worst of COVID appears behind us, there are a lot of unknowns in the world today.

To get through this unpredictable and volatile time, the capital markets – and the businesses, workers, and families that depend on them – need certainty, stability, and prudence. So, translating IOSCO's constructive analysis into anything further should be done in a way that acknowledges this broader international environment and the pressures it is already placing on the asset management industry.

Relatedly, in putting forth any further recommendations - even before being opened to consultation – regulators should distinguish between *aspirations*, some of which the asset management industry likely shares, and their ability to *mandate* meaningful change. For example, while there is scope to improve pre-trade transparency those improvements can't necessarily be forced on markets through regulatory imperatives.

Summary of key outcomes

Q1: What are your views on the key outcomes drawn from IOSCO's analysis of the corporate bond markets? Are there any aspects of the diagnostic analysis and the key outcomes with which you disagree or that would benefit from more nuance? Please be specific to each observation and indicate why.

We broadly agree with the key outcomes drawn from IOSCO's analysis of the corporate bond markets.

Q2: Does the report capture and accurately describe the main features of the corporate bond markets? Is there a particular aspect (or aspects) that may be missing?

We broadly agree that the report captures and describes the main features of the corporate bond markets.

Q3: Are there ways to improve the market functioning and liquidity provision in corporate bond markets, notably under stressed market conditions? If so, please explain how and the extent to which this could be addressed at an international level?

As noted in our response to Q6 below, we note that ultimately the Covid-19 related crisis in corporate bond markets was precipitated by a "black swan" event, and ultimately mainly resolved by intervention by regulators and government authorities (such as central banks). Hence, we do not believe that the Covid-19 crisis itself is necessarily instructive of changes that should be made to the market going forward.

However, we agree with many of the ideas and areas of focus raised in IOSCO's analysis. Increasing transparency, facilitating the use of electronic trading tools, and (to the extent feasible) greater standardization can all help to improve market functioning and liquidity provision going forward. But, as noted in the introduction to our response, any regulatory changes on these topics should be carefully considered. In addition, many of these changes, such as increased use of all-to-all trading, may be market (rather than regulator) driven.

In formulating any next steps IOSCO should consider the state of market liquidity at present. In particular, volatility has increased significantly - including since when IOSCO published the paper in April -and liquidity is thinner. While some of this is cyclical, the macro environment of rising interest rates and relatively high inflation is one that markets have not confronted in at least three decades,

during which time their functioning has changed significantly. All regulators should be mindful of not taking any steps that could inadvertently compound this situation.

Q4: What further work, if any, should IOSCO consider in the context of corporate bond markets?

We believe that some initiatives by regulators will negatively impact liquidity in corporate markets, and IOSCO should consider opposing these proposals. As an example, in April 2022 SIFMA provided comments on the amendments proposed by the SEC to Regulation ATS and Rule 3b-16 under the Securities Exchange Act of 1934. SIFMA believes that the proposed amendments, including in particular the changes to the fair access requirements in Rule 301(b)(5) of Regulation ATS, will reduce liquidity. SIFMA's full response can be found here.

In addition, please see SIFMA's response to the potential application of Rule 15c2-11 to the Fixed Income markets, which is referred to below in response to Q22.

Background of corporate bond markets globally

Q5: Are the features and key characteristics of the corporate bond markets accurately capture and described? Is there a particular aspect (or aspects) that may be missing?

We broadly agree that the key features and characteristics of the corporate bond markets are accurately captured and described.

Liquidity during the COVID-19 induced stress

Q6: Does the report accurately describe the state of liquidity in corporate bond markets during the COVID-19 market stress across the three stated measures employed in the report?

We believe that the report does accurately describe the state of liquidity in corporate bond markets in March 2020. However, in addition to IOSCO's technical analysis on the events in the corporate bond market specifically, we also believe it is helpful to frame this discussion in terms of what was happening more broadly in financial markets in March 2020. As IOSCO states in the discussion paper, the March 2020 episode was triggered by a shock from outside the financial system. The public health crisis in March 2020 caused significant changes in the circumstances of many corporate issuers in a short time period, and a fundamental ambiguity regarding the future earnings of many corporate issuers. This created huge uncertainty in financial markets beyond just the corporate bond markets, which caused a move out of risky assets into safer assets as a result.

Further, there was a general dash-for-cash which affected all asset classes. Firms and individuals sought to liquidate holdings of financial assets or to retain funds (that they might have otherwise lent or invested) in order to hold greater amounts of cash in light of the Covid-19 public health crisis. This often caused knock on effects that spread across asset classes – for instance, withdrawals from mutual funds would place pressure on the fund manager to liquidate the financial assets of the fund.

It was therefore natural that the corporate bond markets showed reduced liquidity during this period. The reduced liquidity in the corporate bond market was not just due to the structure of the corporate bond market specifically, but due to the state of markets generally. We do not believe that tweaks to the corporate bond market structure would solve the problem of reduced liquidity during these types of extreme stress periods. In this context, we believe that the changes to liquidity in the corporate bond markets in March 2020 was to be expected.

Finally, we believe that the report does not emphasize enough the fact that intervention by regulators and government authorities such as central banks was the key factor in restoring liquidity to the corporate bond markets, rather than any behavior of market participants.

The drivers of liquidity – supply, demand, and market participant behaviors

The demand for liquidity

Q7: Do you agree with the overarching analysis of the drivers of buyside investor behavior set out in this section?

We agree with IOSCO's overarching analysis of the drivers of buyside behavior. Our members also witnessed a dash-for-cash and a flight to quality corporate bonds in March 2020.

In particular, we agree with IOSCO's analysis that fund managers who sold liquid assets (which contributed to cash demand in March 2020) may have been acting rationally and in keeping with good liquidity management on an individual basis.

Q8: Are the main demand side drivers of liquidity by investor-category accurately described and reflective of events in your experience of the COVID-19 induced market stress?

We broadly agree with IOSCO's description of the main demand side drivers of liquidity.

Q9: Who in your view were the main drivers of liquidity demand during the COVID-19 induced market stresses and why?

We believe that many market participants were under selling pressures during March 2020, and some market participants saw the crisis as an opportunity to re-balance their investments. We do not believe that any one particular group of investors played a more significant role in selling pressures in the corporate bond markets in March 2020 than others. Similarly, as stated above, the corporate markets of other asset classes (including equities) also faced similar drivers of liquidity demand. Therefore, we believe that IOSCO's report sometimes overstates the selling pressure from open-ended funds during this period.

We would also add to IOSCO's analysis that to the extent that open-ended funds did contribute to liquidity demand, they were driven to do so by redemptions from investors, which forced them to liquidate some of their investments.

Q10: Given mixed evidence, how significant was the behavior of long-term investors in driving or mitigating liquidity demand during the COVID-19 stress?

Due to the mixed evidence, we believe that this is an area that should be subject to further study before any firm conclusions are drawn from it. However, we would observe that it is not clear that the data referenced in the IOSCO paper supports some of the conclusions that have been drawn. Further, a key factor in assessing the behavior of long-term investors is to define clearly what is meant by "long-term investors" as different investors have quite different needs and behaviors.

Many long-term investors needed cash for various purposes during the Covid-19 induced market stresses. For example, sovereign wealth funds and other sovereign investors may have needed to deploy capital towards currency intervention, insurers may have needed capital to pay insurance claims arising from the crisis, whereas long-term investors such as pension funds may have needed to rebalance their portfolios towards cash due to internal risk appetite and limits.

Ultimately, long-term investors do not always just buy to hold and forget about it. They will continue to trade and rebalance their portfolios, and will need to liquidate holdings for various purposes and hence may be influenced by market stresses.

The supply of liquidity – the role of dealers

Q11: Do you agree with the overarching analysis of the drivers of liquidity supply and, specifically, how dealer behaviors are set out in this section? Please be specific and explain why.

No comment.

Q12: What are your views on the relative impact of the drivers of the supply-side in driving the state of liquidity during the COVID-19 induced market stresses?

No comment.

Q13: Considering the drivers of dealer behavior, how could the supply of liquidity be improved?

No comment.

<u>Corporate bond markets' structure and implications on liquidity provision</u>

Q14: Do you agree or disagree with these core features of the corporate bond market? Please be specific and explain why.

We agree with the core features of the corporate bond market as explained in IOSCO's discussion paper.

<u>Dealer intermediation and concentration</u>

Q15: What are your views on the level of dealer concentration?

We note that IOSCO states that a small number of dealers execute most of the trades in the corporate bond market. We believe that this level of dealer concentration is to be expected and that is not overconcentrated. In addition, while we are in favor of diversifying the liquidity supply (away from solely relying on dealer intermediation), we do not believe that we should displace the role of dealers in providing liquidity supply. Dealers offer certain advantages over all-to-all trading (such as the fact that there is no need for sellers/buyers to find an immediate match in the market, unlike all-to-all trading), and so they play an important role in providing liquidity supply in the corporate bond market.

Q16: What could help the market diversify sources of liquidity supply and/or become less reliant on dealer intermediation, particularly in times of stress? Consider both market-led as well as potential regulatory-led solutions.

As noted in our response to Q21 below, we think that the increased use of all-to-all trading is a positive development in diversifying liquidity supply, but ultimately cannot remove the role of dealer intermediation.

However, more generally we would like to highlight that there are elements of market-led innovation that are helping to improve liquidity supply. For example, portfolio trades have become increasingly used in the corporate bond markets because the baskets of securities can be more easily hedged by dealers using index CDS, and ETFs enable portfolio trading through their creation-redemption process. Similarly, there may be more innovation in future as dealers find more efficient ways to advertise their inventory and offer an increased number of trading protocols. So, ultimately, we believe that the regulatory environment should primarily be facilitative towards this type of innovation.

<u>Corporate bond market heterogeneity and standardization</u>

Q17: What are your views on standardization in corporate bond markets? What do you think are the pros and cons of increasing standardization?

There are both pros and cons to increased standardization, as noted in the IOSCO paper. Whilst government bonds and the CDS and interest rate swaps market have seen greater standardization in recent years, this will be much more difficult for corporate bonds, as different corporate issuers have different funding needs, their own profile (e.g. credit risk profile) and are sometimes looking to align their liabilities with specific assets and cash flows. Therefore, we do not think standardization will be beneficial for many corporate issuers and consequently the wider market. However, there may be more of an ability to standardize for more regular corporate issuers – for example banks, utilities and insurance companies – simply due to the greater frequency and regularity of issuances from these types of entities. Nevertheless, even these issuers may be resistant to standardization if it reduces their flexibility.

Growth of electronic trading

Q18: What are your views on electronification of the corporate bond markets? Has it improved the provision of liquidity?

During times of stress, electronic markets are not necessarily impervious to being closed. For example, the London Metal Exchange suspended nickel trading in March 2022 for one week following a record increase in prices of nickel and shut down on occasions following that after significant price movements. Therefore, we do not believe that the electronification of the corporate bond markets would necessarily and by itself improve the provision of liquidity in times of stress. Rather, electronification would need to be considered alongside the broader market structure.

In addition, during times of extreme stress in markets, we do not think electronification helps to solve the problem of greater selling pressures. If there is insufficient supply of liquidity (i.e., if there is a significantly greater demand to sell corporate bonds than to buy them), then electronification does not necessarily improve the provision of liquidity.

Q19: Is the electronification (and any resulting increase in liquidity) of government bond markets over the last decade illustrative of how corporate bond markets could evolve?

As noted in our response to Q17 above, there are significant obstacles to standardization in the corporate bond markets (that go beyond the obstacles present in government bond markets). Ultimately, this is a significant differentiation between corporate and government bond markets, and an obstacle to greater electronification of the former.

Q20: What aspects or developments could help to further support increased levels, and the resilience of electronic trading both in normal times and in stress (e.g., availability of data)?

We believe that greater standardization and greater transparency would be key in supporting increased levels and resilience of electronic trading. However, as noted in our response to Q17 above and Q22 below, there are obstacles to both of these, and hence any changes on these fronts should be carefully calibrated.

Q21: Would an increase in all-to-all trading help the provision of liquidity? Is it feasible to increase its use? What are the pros and cons?

Whilst all-to-all trading can increase the provision of liquidity, we believe that it cannot substantially replace the role of dealer intermediation. Whilst matches may be found directly between trading interests (e.g. two buyside investors) through all-to-all trading, such matches have to coincide in time, and hence cannot play the same role as dealers who have the ability to hold inventory on their

balance sheet. However, it could help to free up dealer balance sheets to an extent, and hence should be encouraged.

Increased transparency

Q22: Do you think there should be more transparency in the corporate bond market, including the level of consolidated information? In which segments of the corporate bond market do you think transparency is most needed?

We agree with IOSCO that there should be more transparency in the corporate bond market. In particular, we believe that greater transparency is needed within the primary markets (given the importance of primary markets in the corporate bond markets) and that this would assist with liquidity. We suggest that transparency requirements in the primary corporate bond markets become less manually intensive, which would encourage greater transparency.

In addition, we believe that transparency requirements should be carefully calibrated for each segment of the bond market, so that they do not discourage dealers from providing transparency over their deals or reduce liquidity. As an example, in September 2021, SIFMA expressed their deep concern about the potential application of Rule 15c2-11 (the "**Rule**") to the FI markets without any adaptation of the Rule to the FI markets. The Rule prohibits dealers from publishing quotes on securities unless certain information review requirements are met, or certain exceptions are applicable. Applying the Rule to the FI markets would risk market participants restricting their quoting activities and reducing liquidity and transparency. SIFMA's full statement on the potential application of the Rule to the FI markets can be found here. This example shows why enhanced transparency requirements need to be considered carefully, since they can sometimes inhibit liquidity.

Q23: Would you consider that pre-trade transparency and post-trade transparency are equally important?

We are of the view that pre-trade transparency in respect of corporate bonds is significantly less valuable than post-trade transparency (given that most corporate bond transactions occur through voice, RFQ systems or bilateral negotiation rather than electronic order books). Hence, applying equities style pre-trade transparency requirements to the corporate bond markets is often problematic due to the fundamental differences in market structure. For example, we note that in the UK, HM Treasury in its "Wholesale Markets Review" is proposing to allow the UK Financial Conduct Authority ("**FCA**") the power to significantly recalibrate the transparency regime noting that "*it is clear that the current regime – which is modelled on the one for equities markets – does not appropriately cater for the specific and often bespoke nature of fixed income and derivatives markets*". We believe that this sort of differentiation between equities and fixed income markets should be borne in mind by regulators going forward.

We believe that meaningful pre-trade transparency is evolving organically in this market, for example through dealer streams. Regulation should be crafted so as to facilitate further organic innovation in this space, and hence mandating particular forms of pre-trade transparency can be harmful.