THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION

# MEETING OF THE
# SECURITIES AND EXCHANGE COMMISSION
# FIXED INCOME MARKET STRUCTURE ADVISORY COMMITTEE

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Washington, D.C.

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2 FIMSAC Members:
3 Michael Heaney, Committee Chairman
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5 Matthew Andresen (via telephone)
6 John Bagley (via telephone)
7 Giedre Ball
8 Horace Carter
9 Gilbert Garcia
10 Tom Gira
11 Larry Harris
12 Scott Krohn
13 Ananth Madhavan
14 Lynn Martin
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16 Richard McVey
17 Lee Olesky (via telephone)
18 Suzanne Shank (via telephone)
19 Larry Tabb
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9 Rebecca Olsen
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1 PROCEEDINGS
2 MR. HEANEY: Good morning. I believe we have a
3 quorum, so let me please call the meeting to order.
4 Thank you all for joining us today at the SEC
5 Fixed Income Market Structure Advisory Committee Meeting.
6 In addition to the members here in person, I believe -- and
7 I have been in and out so I am not sure if everyone is on
8 the phone.
9 I believe we have Suzanne Shank, Lee Olesky, John
10 Bagley and Matt Andresen on the phone.
11 Is that correct?
12 MR. OLESKY: Correct, for Lee.
13 MR. BAGLEY: Yes, Michael.
14 MR. HEANEY: Great. Thank you, John.
15 Matt, are you on the phone?
16 MR. ANDRESEN: Yes.
17 MR. HEANEY: Thank you. And Suzanne?
18 MS. SHANK: I'm here.
19 MR. HEANEY: Okay, great. Thank you.
20 MS. SHANK: Thank you.
21 MR. HEANEY: We were going to begin with the
22 commissioners' opening remarks. I will pause on that and
23 pass it over to Brett Redfearn, director of the Division of
24 Trading and Markets and the committee's designated federal
25 officer for his opening comments.

1 MR. REDFEARN: Thank you, Michael. And I would
2 like to welcome everybody to today's FIMSAC meeting. I
3 would like to first start by introducing my colleagues
4 sitting here with me today. To my right from the Division
5 of Trading and Markets, we have Lizzie Baird, one of our
6 deputy directors. To Lizzie's right are Dave Shillman and
7 John Roeser, associate directors in the Office of Market
8 Supervision within TM. To my left, let's see down there,
9 Rebecca Olsen, director of the Office of Municipal
10 Securities; Jessica Kane, director of the Office of Credit
11 Ratings; and at the far end, Amy Edwards from the Division
12 of Economic and Risk Analysis.
13 Before we get started, I would like to remind you
14 that the views expressed today here from the Staff are those
15 of the speaker and do not necessarily reflect those of the
16 Commission, any commissioners or any other members of the
17 Staff.
18 As this is the first meeting of 2020 and the ninth
19 meeting of FIMSAC, I want to start again by thanking all of
20 the committee members for the hard work and dedication that
21 you've brought to this committee for it seems like a long
22 time now. Your hard work and commitment are evident in the
23 soon-to-be-published SEC Staff report on the second year of
24 FIMSAC.
25 In 2019, the FIMSAC held four public meetings and



1 made five recommendations to the Commission. And the report
2 highlights your work, including recommendations regarding,
3 one, investor education on retail notes; two, certain
4 principal transactions with advisory clients in negotiated
5 municipal underwriting; three, certain principal
6 transactions with advisory clients seeking to liquidate bond
7 positions; four, the practice of pennying in the corporate
8 and municipal bond markets; and five, a FINRA proposal to
9 establish a corporate bond new issue reference data service.
10 It's an impressive amount of work and we appreciate all the
11 time and thoughtfulness that you've contributed to all of
12 these various recommendations.
13 Today, I am looking forward to hearing about the
14 additional issues that FIMSAC is examining, including topics
15 and new recommendations from the various subcommittees.
16 Today's agenda reflects the committee's consideration of
17 some thorny issues, but you have all proven that you do not
18 shy away from any of the challenging topics.
19 The preliminary recommendation regarding municipal
20 issuer disclosure has been the subject of several FIMSAC
21 panel discussions and subcommittee meetings, as has the
22 topic of credit ratings. We are grateful for your continued
23 commitment to these and other topics and look forward very
24 much to today's discussion.
25 I also want to reiterate the importance of the



1 public's engagement in this process. And I commend the
2 committee on the level of inclusiveness that you've shown
3 throughout the process, whether it's inviting participation
4 during subcommittee meetings or as panelists at our public
5 FIMSAC meetings. You've made it clear that the insights of
6 market participants beyond FIMSAC committee members inform
7 the topics you assess and the recommendations of the
8 committee.
9 As always, we recommend that interested parties
10 submit comment letters to the SEC's website. We have a site
11 there for the FIMSAC meetings on a certain webpage. So
12 please, bring any comments that you have; it certainly helps
13 to inform our deliberative process.
14 I would also like to thank the many individuals
15 who are not FIMSAC members who have offered their time and
16 knowledge and continue to participate in FIMSAC's
17 deliberations, including the panelists that join us here
18 today. So thank you all.
19 With that, I look forward to today's discussion
20 and I will turn it back over to Mike.
21 MR. HEANEY: I would like to welcome Commissioner
22 Peirce and ask her for her opening remarks.
23 COMMISSIONER PEIRCE: I will be very brief. I
24 want to thank you all for being here and really appreciate
25 the work that you're doing. I also echo Brett's comment



1 that we welcome the input that people who aren't on the
2 committee who have provided to make your work, I think,
3 really excellent.
4 I'm looking forward to the discussion this morning
5 about credit ratings. As we know, this issue has been a
6 difficult one and there are not easy answers in figuring out
7 how to get rid of conflicts. It's difficult. Every pay
8 model brings with it its own set of conflicts. So I look
9 forward to that discussion.
10 I also look forward to the discussions on the
11 recommendations. I especially appreciated that on the
12 municipal securities recommendation, you all looked beyond
13 just what we can do and made some suggestions about maybe
14 where legislative changes would be helpful. I think it is
15 helpful for this committee not only to think about what we
16 can do, but if there are other things that need to be done
17 statutorily, that you let us know that as well.
18 So thank you all, and I look forward to following
19 the discussion here in person and afterwards. I won't be
20 able to be here all day but I will go back and watch
21 afterwards. I hope the audio quality is better than it has
22 been at past meetings for this meeting. So thank you all
23 very much.
24 MR. HEANEY: Thank you.
25 As reflected on our webpage as Brett referenced,

1 sec.gov, we've had a very busy and productive past two
2 years. I did want to take a minute to update the committee
3 on the work that's been done thus far, to address the FIMSAC
4 recommendations made to the Commission.
5 As you know, we've made 10 recommendations on nine
6 topics. Our first recommendation was for the Commission to
7 conduct a pilot study to assess the impact of the current
8 transaction reporting regime on the market for large-size
9 trades. On April 12, 2019, FINRA published a regulatory
10 notice, soliciting comment on a block pilot framework. The
11 comment period closed on June 11, 2019, and FINRA received
12 over 30 comment letters on this proposal. Market
13 participants were divided on the merits of FINRA's proposal
14 and FINRA continues to evaluate the comments received.
15 Another FIMSAC recommendation that's been advanced
16 is our suggestion that FINRA establish a new issue reference
17 database for corporate bonds, similar to that established in
18 the municipal securities market. On March 27, 2019, FINRA
19 filed a proposed rule change with the SEC that would
20 implement the FIMSAC's recommendation for establishing a
21 central depository for public dissemination of new issue
22 corporate bond reference data. The FINRA proposal was
23 approved by the SEC staff via delegated authority on
24 December 4, 2019. As permitted by law, Bloomberg LP
25 requested that the Commission review the Staff action, which



1 stay the approval pending further action by the SEC.
2 Moving to today's agenda, we have a full day as
3 Brett referenced, four panel discussions and two
4 recommendations to consider. As Brett also mentioned this
5 morning, the credit rating subcommittee will host a panel to
6 discuss conflicts of interest in the payment model for
7 credit ratings and the impact on market structure and
8 efficiency. This panel will be moderated by Amy McGarrity
9 and, as you know, this is not a new topic for FIMSAC. We
10 have hosted previous panels to explore this topic before and
11 receive market participant feedback and we continue to
12 explore the appropriate course of action.
13 The second panel of the morning will focus on
14 preliminary recommendation from the technology and
15 electronic trading subcommittee on improving the
16 transparency for certain types of fixed income transactions
17 reported to FINRA's Trace Reporting and Compliance Engine,
18 generally referred to as TRACE. This panel will be
19 moderated by Sonali Theisen.
20 After a brief lunch break, we will start the
21 afternoon session with preliminary recommendation from the
22 municipal securities transparency subcommittee on the
23 timeliness of municipal issuer disclosures. This panel will
24 be moderated by the chair of municipal securities
25 transparency subcommittee, Lynn Martin. Again, this is not



1 a new topic to the FIMSAC. But based on the prior panel
2 discussions, several subcommittee meetings and public
3 comments, the subcommittee has reached consensus for
4 committee consideration.
5 Finally, we will close the day with a panel
6 discussion on internal fund crosses. Rick McVey, chair of
7 the technology and electronic trading subcommittee, will
8 moderate the panel.
9 Similar to the previous two years, 2020 is off to
10 very busy and productive start. Although it is within our
11 third year, many of you remain dedicated and enthusiastic as
12 we analyze the many aspects that currently affect the market
13 structure of our fixed income markets.
14 I want to join Brett in thanking everybody for
15 their hard work and engagement in this committee's very
16 important endeavors. I would also like to thank all of our
17 panelists today for their participation.
18 Before we begin, again, just a short housekeeping
19 note. Let's continue to turn to the practice of raising our
20 name tags so that we can have a kind of full and equal
21 participation amongst all our FIMSAC members.
22 And with that, let's dive right into our first
23 panel. I turn it over to Amy McGarrity, chair of FIMSAC's
24 credit rating subcommittee.
25 CREDIT RATINGS PANEL CONCERNING ISSUER-PAY



1 CONFLICTS OF INTEREST
2 MS. McGARRITY: Thank you, Michael.
3 Before I begin discussing the work of the credit
4 rating subcommittee and starting the panel, I just wanted to
5 thank Michael, the SEC Staff and the credit rating
6 subcommittee members for their diligent and thoughtful work
7 on this very complex topic. I will just go through some of
8 the things we've been working on over the last several
9 months.
10 You may recall that at our last FIMSAC meeting, we
11 discussed work completed since the global financial crisis
12 on the topic of credit ratings. We heard from a member of
13 the SEC Staff regarding an SEC report and two GAO reports
14 surrounding credit ratings, as well as a number of people
15 proposing alternate payment models for credit rating
16 agencies.
17 The subcommittee continued work along these lines
18 of exploring alternate models and initiatives in addition to
19 continuing to explore the actual need for alternate models.
20 To that end, the subcommittee has created a discussion
21 document, which is posted on the FIMSAC's website along with
22 materials associated with today's meeting. This discussion
23 document is designed to leverage feedback the subcommittee
24 received through its assessment of these issues in exploring
25 an alternate model for credit ratings and other potential

1 initiatives to address potential conflicts of interest. The
2 subcommittee anticipates and welcomes receiving additional
3 industry feedback and will examine that feedback and
4 determine the feasibility of advancing a preliminary
5 recommendation to the FIMSAC in the future.
6 The subcommittee recognizes the complexity of this
7 topic. And as noted, has not developed consensus
8 surrounding a specific preliminary recommendation to present
9 to the broader FIMSAC. I would like to provide some sample
10 feedback. Again, this is not all the feedback we've
11 received, rather a subset from the subcommittee members on
12 cons of the alternate model and other initiatives associated
13 with the discussion document.
14 For example, corporations can currently notify
15 agencies that a deal is coming and facilitate comfort
16 letters to underwriters in diligence within 24 hours.
17 Waiting for an agency to be assigned would significantly
18 slow market access. Corporations share confidential
19 business plans and strategic plans, sometimes potential M&A
20 transactions, with corporate rating agencies. And to
21 propose that such confidential information be disclosed is
22 particularly troubling. Random assignment model needs
23 reworking. A simple change could be that the credit ratings
24 subcommittee continue to examine various models and work
25 with the SEC to seek public comment on these models,



1 suggesting that the subcommittee potentially not offer a
2 specific recommendation to the broader FIMSAC.
3 Some of the pros noted by subcommittee members,
4 again, just a subset, on some of the items in the discussion
5 document include random assignment coupled with the use of
6 legacy NRSROs mitigates some of the concerns surrounding
7 market expertise and institutional knowledge of legacy
8 NRSROs being lost, thus hurting relevancy of ratings.
9 Additional disclosure, including disclosing what a ratings
10 assignment would be if purely based on quantitative
11 application of the NRSRO's methodologies could facilitate
12 increased transparency surrounding potential conflicts of
13 interest or consistent adjustment to sectors and/or specific
14 issues. A random assignment may increase market competition
15 and rather than a race to the bottom to win business, a
16 performance scorecard could be used which could ultimately
17 help inform the random assignment.
18 Just to reiterate, we are looking for FIMSAC and
19 other market stakeholder feedback on this topic. Feedback
20 can be submitted via the FIMSAC's website or FIMSAC members
21 may feel free to reach out to me directly and I will pass
22 information along to the subcommittee.
23 Meanwhile, today we are hosting a panel of two
24 market professionals who will share their views on the
25 functioning of rating agency structure. Each panelist will



1 be given five or so minutes to set the stage for their views
2 on the NRSROs and the structure of the credit ratings
3 process. They may also comment on the proposed alternate
4 models as desired, including the one outlined in the working
5 document. After their introductory remarks, I will ask some
6 questions and then open it up to the broader group.
7 Today, we are joined by Mr. Martin Fridson and
8 David Jacob. I'd like David and Marty to introduce
9 themselves and then have the opportunity to make a few
10 opening remarks regarding this panel topic.
11 Marty, let's start with you.
12 MR. FRIDSON: I want to thank you, first of all,
13 for this opportunity to be of service to financial market
14 participants. My hope is that this discussion will take a
15 broad view, looking not just at how ratings are decided but
16 also at the context in which they are used, which has a
17 great bearing on financial market outcomes.
18 The story is not as simple as credit rating
19 agencies are doing a poor job and investors are the victims.
20 For example, we observed some investment management
21 organizations during good economic times saying, we don't
22 pay any attention to ratings; we do our own credit research
23 which is better than what the rating agencies do. The
24 result of this in-house effort is achieving higher yields on
25 their funds than competitors and thereby drawing in more



1 assets by holding riskier portfolios. When the inevitable
2 economic downturn arrives and their portfolios implode,
3 these same organizations turn around and say, we relied on
4 the rating agencies and they let us down.
5 Now, another point I believe is important is that
6 it would be a mistake to respond to problems observed in
7 asset-backed ratings by imposing unnecessary and potentially
8 counterproductive regulations on corporate credit ratings
9 where the system is functioning well. In saying that, I do
10 not contend that corporate ratings are perfect. I have
11 published analysis indicating that the agencies are slow to
12 upgrade ratings from triple C to B, when such upgrading is
13 warranted. Recently, I showed in a study that agency
14 ratings are less useful than market-derived risk premiums or
15 yield spreads over treasuries in managing exposure to
16 general market declines. This work was published in a
17 research series I produced for LCD, a unit of S&P Global
18 Markets that is not involved in producing credit ratings.
19 So I am going to leave it at that. Thank you
20 again, and I look forward to a very productive discussion.
21 MR. JACOB: Good morning and I am really happy to
22 be here. I have been on Wall Street from the sell side,
23 research side and my last experience, which was an
24 unpleasant one, was at a rating agency. I was brought into
25 S&P at the end of -- in the middle of the financial crisis

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1 to take over the structured finance business. And I had
2 many reservations about joining at that time and I can tell
3 you some of my experiences there.
4 I think I agree with Marty. And Marty and I have
5 known each other for probably 35 years. We used to work
6 together many, many years ago. I -- and I was an analyst,
7 actually, on the corporate side for a very brief time at
8 Moody's at that time in 1983.
9 Having been in structured finance most of my
10 career, I appreciate the work the committee has done in
11 various other areas in fixed income. But I would say, from
12 my experience, this is unique to structured finance, the
13 problems that you're discussing here today. There are some
14 examples of ratings that go awry, I'm sure, in corporates
15 and all kinds of pressure. But I don't think it's anything
16 like what I experienced and what I saw from both sides, from
17 the sell side and from the rating agency side in structured
18 finance. And even within structured finance, the pressures,
19 as we know from the financial crisis, really were in the
20 mortgage-backed area, mostly residential and somewhat in
21 commercial.
22 We sit here and again I am interested some on your
23 proposals. But I think I didn't see anything in there about
24 looking at the pressure that might be brought to bear or
25 restrictions that might be brought to bear on the behavior

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1 of the issuers. Because the issuers in structured finance
2 are very, very different than the issuers in corporates and
3 municipals. Those areas, they're raising debt and they're
4 in the market continuously raising debt. These are pure
5 arbitrage type issues in structured finance. And the
6 incentives of the issuers are different and therefore their
7 behavior in the marketplace, putting pressure -- or the
8 rating agency. We can blame the rating agencies, yes.
9 There's a lot to blame there. But a lot of that strives
10 from the pressure on the issuer side.
11 And having been on the issuer side in CMBS, I will
12 say I didn't participate in it, but I certainly observed it,
13 and it's fierce. And there's, of course, courting the
14 analysts as well as absolute pressure at the -- when it's
15 coming to choose who are you going to choose for the rating.
16 And there's pressure, of course, from within the rating
17 agency itself, from the most senior management. I reported
18 to the president of S&P. And I can give some specific
19 examples where I felt it and I had to go to compliance. But
20 I have a number of issues that we'll talk about today that
21 hopefully you'll find helpful. And some ideas for you. And
22 I'll give you my comments on the random assignment as well.
23 MS. McGARRITY: Great, thank you. And as we
24 progress and I ask questions and if we don't get to all of
25 them, if I'm not covering something that you'd like to get

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1 into the public realm, please just feel free to do so at any
2 time.
3 Just to kick it off, in your opinion, how has the
4 market for credit ratings changed since the global financial
5 crisis? There's been a lot of discussion, some regulation
6 surrounding credit ratings. What has changed both good and
7 bad, in your opinion, since then? Marty, did you want to
8 start?
9 MR. FRIDSON: Okay. Well, the agencies make the
10 case that they have enhanced the separation between the
11 commercial side of the business and the rating process. You
12 know, of course, I don't audit that procedure. But I think
13 that there certainly was impetus for that from the financial
14 crisis.
15 The one noteworthy change on the corporate side
16 has been a change in the distribution of ratings within the
17 corporate bond rated universe and that may reflect some
18 tightening of standards by the rating agencies since the
19 financial crisis. Specifically, the -- there's been quite a
20 bit of attention to the fact that half of the investment
21 grade corporate bond universe is now rated in the lowest
22 category of triple B. Depending on what base period you
23 look at, that is up from as little as one third to slightly
24 under 40 percent. And I and others have shown that that
25 change has been primarily the result not of issues getting

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1 downgraded from triple A, double A or single A, but issues
2 that did not have corporate ratings prior to the last few
3 years coming into the market and initially getting triple B
4 ratings.
5 The significance of this in particular is that
6 there is a concern that the speculative grade or high-yield
7 market will get overwhelmed with downgrades from the triple
8 B sector coming into the speculative grade range. I think
9 those fears are somewhat exaggerated because, again, it's
10 not a situation of declining credits that are causing that
11 triple B sector to expand. So there has been some change in
12 the outcome.
13 I think we have continued to see growth also in
14 the lesser ranked, just in terms of volume and, you know,
15 market shares, continued development among rating agencies
16 beyond Moody's, Standard and Poor's and Fitch and expansion
17 of those agencies in the areas in which they're seeking to
18 rate. So those would be some of the things I would
19 highlight.
20 MR. JACOB: I think in structured finance, it's
21 begun to deteriorate again. I think they -- the criteria
22 are being eased in order to facilitate new issuance. And
23 that's a problem which we are looking at, I think. And
24 seeing today there have been a number of articles recently
25 in the press about, you know, specific issues. So I would

1 say -- and, by the way, this is, you should understand that
2 all a rating agency has to do is publish criteria. And
3 they're required by law to follow those criteria. It is not
4 incorrect or against any regulation that I know of to change
5 your criteria.
6 But, you know, in terms of the market, if criteria
7 are weakened in order to be able to give higher ratings,
8 then that's setting the market up for the same problems that
9 we had before. Although in the first case, it was probably
10 cases of fraud within structured finance. But if you follow
11 the way things are set up, the way the structure of ratings
12 are in structured, you have your criteria, you publish your
13 criteria, you follow your criteria, that's okay.
14 And so a rating agency that wants to get business
15 -- again, I should point out, it doesn't take much in
16 structured finance to alter the profitability of a deal. It
17 takes just small amount of change in criteria, a little more
18 triple A, and your deal goes from being unprofitable to
19 profitable. And these nuances can make that happen.
20 So if you asked me how it's changed, if that was
21 the nature of your question, how things have changed, I
22 think the criteria are changing in the direction of getting
23 weaker again. That's one of my recommendations for you, is
24 if you want to follow this, you know, you can definitely try
25 to see how criteria get changed in the place of market



1 share. So if suddenly you see a rating agency's market
2 share has gone down and suddenly they're starting to weaken
3 their criteria, well, it is a bit of a red flag. But I'm
4 not sure now, the way regulations are, there is anything you
5 can do about it. It's just the way the marketplace is in
6 ratings. You change your criteria and you rate according to
7 your criteria.
8 The problem -- and I will say, this is an
9 experience that I had post the crisis. While I was there,
10 and you probably know this, I'm not going to mention the
11 analyst's name, but there was a case of an analyst who
12 worked for me while I was there -- now, we're post crisis --
13 who actually didn't follow the criteria, went off and
14 decided to do the rating not following the criteria. And
15 then, of course, she got slapped with a fine by the SEC. I
16 can tell you more about the case if you're interested in it.
17 But I can tell you that the penalty there -- and
18 here is another recommendation for you -- the penalty there
19 was miniscule. It was $7,000. You know, a person making
20 hundreds of thousands of dollars a year getting a penalty of
21 $7,000 doesn't sound too much to me. So maybe one of the
22 things you can do -- and I think it's right to slap the
23 analyst.
24 If an analyst -- you know, analysts are getting
25 pressure within the organization.



1 Oh, I want to mention what Marty said about the
2 separation and what that -- you know, the separation of
3 commercial and business side. But, you know, an analyst, if
4 they're personally going to be held liable and personally,
5 financially hit for doing something that's problematic, I
6 think that's a good thing. But if you're going to have a
7 penalty of $7,000, it doesn't work.
8 Now, in terms of the separation, that was
9 instituted back then in 2008, '09 -- I mean -- yeah, 2009
10 after the crisis. That was part of this idea within S&P was
11 to separate out commercial and analyst side. As head of
12 structured finance, I ran both. So I had both parts
13 reporting to me and they were supposed to be separated.
14 Supposed to be.
15 But look, to be honest, the bonus pool is
16 generated by the business that gets done. That's it. And
17 so I was told, well, you guys didn't generate that much
18 business this year, this is the size of the bonus pool for
19 structured finance and you have to allocate this pay to
20 those analysts. So while the analysts may try to do the
21 right thing of not rating it or not rating it higher to get
22 the business, within the organization it's very, very hard.
23 Think of it. How do you really -- how do you pay people?
24 You pay people from the profitability of the company. If
25 you don't do ratings, you don't make profits. You don't



1 make profits; you can't pay people. So one of two things
2 happens, either they get paid poorly or they reduce the
3 number of analysts that are there because they can't make
4 money. Making money means writing deals. You don't get --
5 make very much money from doing the surveillance ratings,
6 it's the new issuer ratings.
7 And so no matter how you slice it, it's really
8 hard to say that they're really separated because that's how
9 they get paid. And if you said, well, you have to separate
10 it, you know, the bonus pool is separate. Separate bonus
11 pool, that's all great. But if there is no money to pay
12 them, I can tell you, McGraw Hill is not paying them.
13 MS. McGARRITY: David, you mentioned something.
14 And actually, Marty, you did too, specifically surrounding
15 structured products. And I think that there were some
16 provisions in the Department of Defense-Frank legislation
17 specifically designed to increase competition amongst
18 NRSROs. I'm alluding to Rule 17g-5, which allows some
19 unsolicited ratings -- I'm paraphrasing -- which our
20 subcommittee has explored and commented on.
21 What are your views of the impact of 17g-5 and are
22 there any aspects of it that you think would be beneficial
23 to change?
24 MR. FRIDSON: Well, as David can elaborate on
25 more, we have not seen a lot of movement toward unsolicited

1 ratings. And, you know, there is the question of recouping
2 the cost of issuing those. And then there are other
3 technical issues with them.
4 The, you know, one provision had to do with not
5 issuing a rating if it represents more than 10 percent of
6 the revenue, which is not going to be an issue for the
7 larger rating agencies, certainly not in the corporate area.
8 Part of the problem in the structured finance area was the
9 concentration on the issuer side. In other words, instead
10 of many companies out there that are raising money, need the
11 money, have to get a rating to get the money, in the
12 corporate area, it was standard that the investors expected
13 ratings from at least Moody's and Standard and Poor's. So
14 there was no ability to play one of those off against
15 another. And if you represent only a very miniscule portion
16 of the rating agency's total revenues, another reason you
17 don't have much leverage over them.
18 In the structured finance area, it was not
19 established that ratings from both Moody's and S&P were
20 required and therefore there was ability to ratings shop
21 even between those two major agencies. And there were just
22 a handful of banks creating these structured finance deals
23 which were not going to happen and there was not going to be
24 any revenue to the rating agencies unless they got the
25 triple A senior tranche. So a very different environment.



1 And I think it gets into that very basic conflict
2 of interest issue. Because to say there's a conflict of
3 interest is not automatically to say that the conflict of
4 interest cannot be managed with the right incentives and the
5 right structure. But there was a very sharp contrast in the
6 structure between, you know, the structured finance market
7 and the corporate market at the time.
8 MR. JACOB: So let me first completely agree with
9 Marty on the issue about the concentration of issuers in the
10 structured finance area. It's a big deal if you lose one of
11 the big issuers in getting ratings. So if you lose one of
12 the guys who's doing most of -- a lot of the deals, then it
13 really hurts your profitability. And that is unique to
14 structured finance. When I was at Nomura and we were
15 leading in the CMBS area, you know, the rating agencies
16 solicited our business. They wanted to do it because we
17 were a very large issuer in the commercial mortgage-backed
18 securities market at Nomura. And so that created definitely
19 that kind of conflict.
20 In the area of unsolicited ratings, again, from my
21 own experience, I can tell you at S&P I tried this. So we
22 weren't really -- my firm didn't allow us to do actually --
23 so when we're losing deals, I used to have to publish --
24 this is just funny by itself. So for my board at S&P, the
25 McGraw-Hill board, once a month I had to publish a report



1 for them as to why we were losing business. And there were
2 different categories. So there was you didn't provide -- so
3 the analysts would come back, why we didn't get the deal,
4 come back to me and tell me why we didn't get the deal. So
5 what are the possibilities? It was bad service, they
6 weren't fast, the fees were too high, so on and so forth.
7 But also one of the categories was the criteria
8 were too severe. And month after month, I would go to the
9 board and say, here's why we didn't get this deal, here's
10 why we didn't get this deal. And I'd say nine out of 10
11 times it was because of the ratings.
12 You know, S&P at that time had toughened things up
13 because it was after the crisis. And we weren't getting the
14 deals as much as some of the others.
15 So I decided as head of the group, okay, I want to
16 try some unsolicited ratings. The company itself -- so
17 McGraw-Hill was a little uneasy about it. You know, because
18 again, if you do an unsolicited rating that looks bad, you
19 piss off the issuers and they're not going to come to you.
20 Now, it was easier at that time because, remember,
21 market issuance after the crisis was very, very low, because
22 things were recovering. So there was -- my perspective, as
23 head of the business, I didn't think I was going to lose
24 that much and I was hoping to correct the market.
25 So they wouldn't let me do unsolicited ratings.



1 And they're right because, and this is an issue I want to
2 get to, in structured finance, you don't have a lot of the
3 information you need to actually do a rating unless you're
4 chosen. You don't get that kind of information. You give
5 preliminary feedback if they come to look at you but you
6 don't have sufficient information. And so that's one of my
7 other recommendations.
8 The mantra at SEC, as far as I know all my career,
9 was disclosure, disclosure, disclosure. Not rating -- not
10 evaluating risk. SEC doesn't want to be in the position of
11 evaluating risk, but they want disclosure.
12 In structured finance in my view today, still,
13 there is not sufficient disclosure to actually do an
14 unsolicited rating.
15 So what I did do and tried this out so I can give
16 you what happened, I did what I called unsolicited
17 commentary. That's what we titled them. I did this a few
18 times.
19 So I got my analysts together and said, we weren't
20 chosen, okay. Let's try to do a commentary the best we can
21 on these new issues.
22 So it wasn't easy and it wasn't complete. I mean,
23 I didn't feel we could do a rating because we didn't have
24 the information. But we published unsolicited commentary.
25 Again, McGraw-Hill was a little uneasy on this.

1 And the critical part here you should note is
2 you've got to do this before the issue actually comes out.
3 Because if you do the commentary after the deal is done, you
4 can really make investors unhappy. Because if your
5 commentary indicates that the deal wasn't -- the ratings
6 were not good or given by the other agency were too high,
7 then the investors get really angry because they just bought
8 the deal. So you have, again, a very small time frame.
9 Which, by the way, in the corporates I can understand why
10 there is pressure to issue the deal because they want to
11 raise the debt. I don't know why there's this anxious
12 pressure within structured finance why they have to issue
13 the deal this week, because it's just an arbitrage. Right?
14 So, you know, it seems to me that it would be good if you
15 could get the information out there so that unsolicited
16 ratings could be done.
17 Anyway, I published a couple of commentaries and I
18 got some feedback from investors, institutional investors,
19 like in terms of pension funds and others. And I got some
20 good feedback. People said, oh, that was really good. Can
21 you give us a rating? They said, great to have the
22 commentary but it's not a rating. I said, I'm sorry, I
23 can't give you a rating because I don't have the information
24 to actually give you a rating.
25 But I did get, you know, some good positive



1 feedback about the unsolicited commentary from investors.
2 The issuers weren't thrilled, naturally.
3 MS. McGARRITY: So I guess just jumping back a
4 little bit, this may seem like an obvious question. But
5 what do you think the primary purpose of credit ratings is
6 and who do you think are the primary beneficiaries of credit
7 ratings in today's market? Who should be the primary
8 beneficiary of credit ratings and how does the answer to
9 this question inform how we assess the pros and cons about
10 the current market structure for credit ratings? David, do
11 you want to take this one first?
12 MR. JACOB: Okay, I'll try. It's a good question.
13 I think it's an important question about why ratings exist
14 and who should be using them.
15 Clearly, the most -- the biggest reason why we
16 have ratings in my mind is because regulatory bodies require
17 them from financial institutions. So that's the first
18 thing. They say you have to have investment grade or it has
19 to be a certain rating category. I think pension funds have
20 requirements also. So that's -- it's to satisfy regulatory
21 or investment guidelines that they're set up to be used.
22 I think that if they had their choice, major big-
23 size institutions would use their own analysts in many
24 cases. You know, I'm sure in corporates, they do look at
25 the financials and they make their own assessment and



1 judgments as to what the risk and credit risk would be in
2 these various securities. In structured, they might do it
3 too for standard deals. An institution of a big size might
4 be able to do it. The problem is there are small-size
5 institutions, smaller pension funds who don't have the
6 ability to provide the rating or come up with the analysis,
7 their own in-house rating. And so they would be a
8 beneficiary of this, the smaller institutions. Also funds,
9 some of them are smaller funds and they don't want to spend
10 the time.
11 And so I think investors, you know, clearly also.
12 But I think the largest institutions I spoke to, you know,
13 when I was doing these. And they said, we don't mind if the
14 rating actually is wrong because then we can -- we might be
15 able to take advantage of the marketplace if they are able
16 to do their own analysis. And so they would feel
17 comfortable maybe making a purchase or not making a
18 purchase.
19 Of course, in fixed income, unlike equities, you
20 can't short. And you surely can't short a new issue. So it
21 would only be good if the rating were favorable from the
22 investor's standpoint. If the rating were too low, then
23 they may be able to purchase it and get a good deal.
24 I should make a point which we haven't discussed
25 here but I should say, and you should focus at this. I'd



1 urge the committee to do a little differentiation in your
2 analysis of new ratings and surveillance.
3 So new issue ratings, first of all, that's where
4 the profitability actually is for a rating agency. Most of
5 the money is paid for a new rating. And this was part of
6 the problem during the crisis. There's almost no money you
7 get from doing surveillance. Which is why they tended to
8 put, you know, not such great top analysts on the
9 surveillance side.
10 So surveillance really is important for investors
11 because you want someone watching it after the new issue.
12 These deals last. And if there's not much incentive to look
13 at and get paid to do surveillance ratings, well, you know,
14 what have you really done? Who have you really given the
15 ratings for? It's for the benefit of the issuer. And you
16 may say you care about the investor. But if you're really
17 not watching the deal in surveillance, that's a problem.
18 And that's a problem you should look at, you know, in terms
19 of who's the user. I think, you know, and they trade in the
20 secondary market. If that rating is not updated -- and
21 again, you can't rate it yourself without the information --
22 I don't know. I think that's a real big issue on the
23 surveillance side.
24 MR. FRIDSON: Yeah, I would just carry David's
25 point a little bit further as far as who are the users. I

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1 think in economic terms, the real beneficiaries, the reason
2 the rating agencies exist, is because of the end investors
3 who are not equipped at all, I think in many cases, to do --
4 and don't have the resources or the desire to do the
5 underlying credit analysis. They are hiring professional
6 money managers so they are the principal hiring an agent.
7 And then you automatically have potential principal/agent
8 conflicts that arise.
9 So imagine the official at a small city
10 responsible for the city employees' pension fund doesn't
11 have resources to micromanage the portfolio, hires a
12 manager. If that official puts in a rule that says we're
13 going to have a minimum rating of, let's say, single A for
14 bonds purchased for this portfolio, that fund will probably
15 miss some great upside opportunities. On the other hand,
16 the fund will not blow up and leave the municipal employees
17 without their pensions.
18 And putting this in protects this fund against
19 excessive risk taking by the manager. Now, you might ask,
20 why would the portfolio manager take excessive risk? This
21 outside manager that's been hired. And there are clear
22 reasons why that could happen. For example, suppose a
23 manager has underperformed for one year, two years in a row,
24 figures after the third year, I'm going to get fired if I
25 don't get back to at least matching the benchmark that I've

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1 been assigned. Well, the economic incentive in that
2 situation is a hail Mary pass, take as much risk as
3 possible, hope to get back up. If it doesn't work, you're
4 going to get fired anyway.
5 So these are situations that arise in the real
6 world where that kind of risk taking could occur without the
7 real knowledge of the end investor who -- you know, who is
8 protected by having the ratings in place. So I think that's
9 the economic rationale when you analyze it of why there are
10 rating agencies out there. And I think the focus, as David
11 has rightly pointed out, you have to look at the issuers the
12 investment banks, the underwriters of those deals, their
13 actions, how that affects the rating process and the outcome
14 from ratings. And also, it's not as if the buy side, which
15 I am on, is entirely free of blame in this as well. Because
16 there are actions taken that again abuse the way the ratings
17 are used and, you know, the question of how one might go
18 about trying to police that. But I think it's important to
19 understand that as a part of the whole process, again,
20 rather than focusing entirely on what analysts are doing to
21 come up with the particular rating that is issued by the
22 agency.
23 MS. McGARRITY: Thanks. And you guys just touched
24 on this a little bit. But part of the Dodd-Frank
25 legislation included requirements to reduce the SEC rules'

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1 reliance on credit ratings. And there has been a lot of
2 work done here, so there is definitely much less reliance on
3 credit ratings.
4 That said, we've heard a number of times
5 throughout our research including right now that investors
6 continue to rely on ratings, the public pension plans, et
7 cetera, mom and pop investors, specifically through their
8 use of indexes, which may require ratings by particular
9 NRSROs and/or the investor guidelines may refer specifically
10 to NRSROs and/or credit ratings themselves.
11 Do you have any thoughts on this? We've asked --
12 we've racked our brains over this topic. Do you have any
13 ways the SEC or other regulators may influence this
14 remaining legacy issue?
15 MR. FRIDSON: Well, I think that in the case of
16 the professional money manager, it ought to be the case that
17 that manager is doing independent work, you know, taking a
18 look at the ratings. One factor that almost never gets
19 mentioned is that in the case at least of Moody's and S&P in
20 the speculative grade area where I've really focused my
21 research, in addition to the work I do on the money
22 management side with Lehmann Livian Fridson Advisors, there
23 in the speculative grade area, there is a rating outlook
24 published on every speculative grade rating. So when -- you
25 know, the rating -- which is to say the rating is likely to

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1 go higher or lower or remain stable over a somewhat defined
2 period, might be a year and a half or so. Or,
3 alternatively, if there is a major event out there such as a
4 proposed merger which is likely to have an effect, the
5 rating won't change until that is resolved. But there will
6 be a watchlist saying the rating is likely to go higher or
7 lower based on the implications of that development.
8 Those outlooks and watch listings, as far as I
9 know, never get mentioned in any of these discussions of how
10 the ratings distribution or minimum rating levels or
11 anything else are used in indexes and so on. But it's quite
12 important and the market does tend to agree with those
13 views. As much as the money managers say that they're
14 independent, do their own work, you do tend to see a
15 tendency of the issues that are at a given rating but with a
16 negative outlook will tend to have a wider spread over
17 treasuries, indicating a rare condition that there is a
18 substantial risk that the rating will go down from there.
19 There are exceptions to that and those are interesting cases
20 for investors to look at. But, you know, as the market
21 reflects this, the criteria don't.
22 You know, in the case of a major high-yield bond,
23 so called, that failed a couple of years ago, there were --
24 the ratings were disclosed. It wasn't emphasized in the --
25 you know, the regulations that it applied didn't pick up on

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1 the fact that the bonds int that were overwhelmingly
2 distressed issues recognized by the marketplace with yield
3 spreads of a thousand basis points or more over treasuries.
4 And those are generally rated triple C but not in every
5 case.
6 So again, if you look at it and just say, well,
7 did it meet the rate? What was the ratings mix in the fund?
8 You might have been perfectly content right up until the
9 time that they attempted to suspend redemptions of the fund
10 because of the massive problems that arose.
11 So I guess there is somewhat more to the story.
12 And again, disclosure, I think as Dave has rightly pointed
13 out, could be a way to address some of these concerns.
14 MR. JACOB: I'm not sure I completely got the
15 question but I will give some comments again, because I
16 raised this before about the secondary and new issue market.
17 So again, in the secondary market, and when they
18 -- well, first let's get to a the primary. When you do a
19 new issue in structured finance, remember I said that the
20 profitability can be easily changed by small changes, minor
21 changes in the amount of triple A you can get in the deal.
22 So again, that's how we get positive profit of the deal from
23 having triple As, you get negative profit of the deal from
24 having a lot of lower rated securities.
25 And so what happens is, as the issuer is talking

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1 and negotiating, I guess you would call it, with the rating
2 agency. And you say, well, what do I need to do to bet this
3 much triple A? How much -- you know, what's the minimum
4 number of credit support I need at the double A level to get
5 me triple A bonds. And so as a result of that process, what
6 you really end up with is bonds that are at the minimum
7 level of the threshold to satisfy being in a AAA bucket or a
8 double A bucket and so on. Which means those initial
9 ratings are kind of like at the precipice of being below
10 that. In other words, they just found how much do I have to
11 be to be exactly at that point so you don't give me a double
12 A on the bond, you give me a triple A. Which kind of sets
13 you up, you know, for going forward. If there's any
14 deterioration, you really should be going down in the
15 rating.
16 As I pointed out before, the process of doing that
17 surveillance is something that was lacking and my guess is,
18 although I've been out of it for a while, because there's no
19 money made in that, there's very little in the watch. And
20 so you do put things on watch. And of course, in
21 structured, when things go on watch, it's generally not
22 individual deals. It could be. But it could be like a
23 whole big sector that gets put on watch. But it could be an
24 individual deal.
25 But it was just so bad, I have to tell you. My

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1 experience with the surveillance group was really bad.
2 One thing I will just point out for the record,
3 having been on the issuer side as well, the view by the
4 issuers of the analysts at the rating agencies is like
5 they're really stupid, they're really dumb people over
6 there. They have no respect for that. And it's just a
7 matter of how far they feel they can push them one way or
8 another. So there is this.
9 And on the other hand, you have the analysts who
10 are at the credit rating agencies who are maybe hoping, some
11 of them to get a job with the investment bank, because
12 they're going to get paid, you know, twice or three times
13 the salary. And so they, of course, also kind of like don't
14 want to get too -- the issuers too angry at them.
15 So these are some of the dynamics you may not
16 observe in some of these meetings. But when you're part of
17 the organization, you do.
18 MS. McGARRITY: Thank you. Let's move on to maybe
19 some of the ideas put in the working document that we have
20 online.
21 Do you believe that ratings agencies should be
22 required to share their ratings methodologies with the SEC
23 and the public? If ratings agencies were required to
24 provide additional disclosure, for example disclose when and
25 if they deviate from their stated methodology, do you see

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1 any issues with this? What other types of disclosures might
2 be valuable?
3 David, do you want to take it first?
4 MR. JACOB: Well, I thought already they are
5 required to, one, publish their criteria, and they're
6 required to follow their criteria. And I think that's
7 absolutely a minimum requirement.
8 One of the things before the crisis and, you know,
9 I have to be honest, I ran this group. And I've always
10 looked at ratings. But I never really understood how a
11 rating really gets done. I was never a rating analyst. And
12 I just said, gee whiz, how do you differentiate some of
13 these? I can see that's risky, that's less risky, that's
14 very risky. But these fine gradations I thought were very,
15 very interesting.
16 And one of the ideas put forth by rating agencies,
17 which I don't think is true, is that there's a notion of
18 ratings comparability. So the criteria across sectors are
19 supposed to create this idea that a triple A in one sector
20 is the same as a triple A in another sector and another
21 sector. Whether it's, you know, corporates or a credit card
22 deal or CMBS or RMBS, it's all supposed to be the same
23 thing. Municipals.
24 You know, I live in a village in Long Island where
25 we have a triple A rating. And there aren't too many triple

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1 A ratings out there. And it's really hard for me to believe
2 that my village has a better credit rating than, I don't
3 know -- are there any triple As in corporates?
4 MR. FRIDSON: A small but diminishing group.
5 MR. JACOB: But even a double A. It's hard to
6 imagine that. And so on.
7 And so that notion of comparability is probably
8 not there. But still and all, publishing the criteria, I
9 mean, this analyst, again, the SEC then fined who worked for
10 me, she deviated from the published criteria. And so, you
11 know, of course she deserved to be penalized for that. It
12 seems I think that's against what the regulation actually is
13 to deviate.
14 So publishing criteria, I think they could do a
15 better job at making them more precise, more exacting. I
16 have a friend, Mark Adelson, who was running the criteria
17 credit group at S&P when I was there. He also joined to try
18 to fix the place up. And he said to me he thinks that, you
19 know, it's possible to actually publish criteria which if
20 any analyst on Wall Street had the data, they could actually
21 come up with a very close rating. And if that were really
22 true, I think I would definitely be a proponent of that. So
23 that, you know, again, we need the information. But that
24 you should follow the credit rating criteria and come up
25 pretty close to the rating they come up with.

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1 And I think any changes to criteria, of course,
2 have to be published. I think they are required to be. But
3 to the extent that people can understand them and use them
4 and actually rate the deal if they had the information, I
5 think that would be definitely good.
6 MS. McGARRITY: Thanks.
7 MR. FRIDSON: Yeah. Again, I think this is an
8 area that you have to differentiate on the structured side
9 and the corporate side. You know, not in any way to
10 diminish the thought that goes into the ratings on the
11 structured side. I think there is a larger statistical
12 component to it. And I think probably more definable to
13 look at the criteria, the default experience on the
14 underlying collateral and so forth.
15 On the corporate side, there is a significant
16 qualitative factor. You have only the company's historical
17 performance, which in theory has no bearing at all because
18 all that matters is what happens in the future when the
19 bonds are outstanding. Realistically, the historical
20 experience is going to give you some guidance as to what's
21 likely to happen. But in the case where you have disruption
22 going on in the industry, we could certainly point to
23 industries such as retailing that look very different from
24 what they did just a few years ago. And I don't think you
25 want to create a situation where the qualitative factors are

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1 suppressed or rating agencies are hesitant to make those
2 calls because they're concerned, well, this will look like
3 we're deviating from our model.
4 I think that ultimately, the marketplace makes a
5 determination whether the ratings are credible or not. And
6 if they are deviating and bad results are coming from that,
7 that is going to show up in the market's assessment of the
8 agencies. But one of my favorites in this has always been
9 the quality of management, which trying to get people to
10 define on what that means, how do you assess that? I mean,
11 you can look at the performance of the management up until
12 then. Beyond that, I think we've had certainly some
13 dramatic examples of world's best manager suddenly falling
14 to world's worst manager. And so there's a lot of
15 perception involved in that. But it is clearly very
16 important, the quality of the leadership in a corporation
17 over an extended period of time is clearly going to have a
18 major impact on their financial performance.
19 MR. JACOB: I think you have the benefit in many
20 corporates of looking at the equity. So you have an ongoing
21 monitoring by the marketplace that's trading the equity and
22 seeing -- and that's not rated but still that's a public and
23 it's an instantaneous reaction, as I say, possibly to credit
24 situations where it's structured. Of course, there is no
25 equity. There's nothing to watch. And so we have a

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1 different -- that group with the investor market.
2 MS. McGARRITY: The next question I have is, what
3 are your views on random assignment, including using a
4 legacy NRSRO, in addition to a random assignment, along with
5 the ability to opt in, opt out? Specifically related to
6 your comments from earlier, David, you in particular
7 discussed how unsolicited ratings are relatively difficult,
8 especially on new issues, because of the timeliness of them.
9 But then you also indicated that you didn't see why they had
10 to rush to market.
11 So I'm just, I guess, marrying the two concepts of
12 random assignment to the timeliness to market, the opt
13 in/opt out, what are your thoughts on that?
14 MR. JACOB: I've spent some time thinking about it
15 since you sent that to me to look at. And I haven't come up
16 a hundred percent with the conclusion. I don't see anything
17 wrong with it. I think it's interesting.
18 Now, let me discuss some of the pros and cons in
19 my own thinking as I've thought bout it. And I think you
20 try to address this.
21 Of course, the first thing is the payment to the
22 rating agency. As Marty pointed out, when you do an
23 unsolicited or your random assignment that's listed, I mean,
24 that's the idea, right? You're going to randomly assign
25 someone who wasn't chosen.

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1 And so, yes, you could put in a fee there that
2 they're going to get. It should be, obviously, a fee that's
3 similar to what they would get had they been chosen. It
4 can't be like a really low fee. Because I guess you could
5 force people to take a low fee but it sort of doesn't seem
6 right because they're putting in the work. So that's okay.
7 And it could help because it was randomly assigned.
8 In particular, it's probably one of -- again, in
9 structured finance, we have two major agencies but there are
10 some others that are trying to be in the marketplace. Well,
11 Fitch has always been involved in structured. But there are
12 others like Kroll and Egan-Jones and others that have tried.
13 But there aren't that many.
14 So when you talk about random assignment, I guess
15 it's good if there were like 10 of them and they all had
16 decent market share and they all had staffs to do this. I
17 guess, in theory, it could be good. But I think the current
18 structure of the market, I'm not sure exactly how you would
19 be able to implement that.
20 But let's say, you know, especially with some of
21 the smaller deals, not the big deals, sometimes rating
22 agencies -- I mean, sometimes issuers can go with one rating
23 agency. So then, yeah, that certainly could be a good
24 thing.
25 It doesn't completely get away from the problem of

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1 that rating agency not wanting to anger a large issuer.
2 Remember, issuer in structured finance means someone who
3 aggregates pools of assets and creates a portfolio and does
4 this. So, you know, even if you're randomly chosen, you
5 know, at that point do you still go and say, well, I'm going
6 to rate it as I really think it should be rated? Again,
7 they have to follow the criteria. But let's say there's
8 some wiggle room there in the criteria. Would I rate this
9 to make the issuer angry at me or would I rate this to make
10 the issuer happy so the next time they do choose me. And so
11 I'm not sure you completely get away from that problem.
12 They could say, well, you know, I didn't want to
13 rate it. You came to me; you know what I was going to give
14 you. But, you know, so maybe to get the right rating, you'd
15 have to get the rating they would have given when they were
16 being shopped. So let's say Morgan Stanley goes to rating
17 agency X. And rating agency X says, oh, this is our
18 criteria. You're going to get like only, you know, I don't
19 know, 50 percent triple As. Say, oh, we don't want you.
20 So now, SEC comes in and says, you weren't chosen;
21 we're going to choose you. It would have been nice to know
22 what their rating would have been, had they been chosen, to
23 make sure the rating that they get is the same rating had
24 they been chosen. You know, you see what I'm saying?
25 So I'm not sure this issue of not doing the right

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1 rating because you're fearful of the issuer's pressure on
2 you for future deals, I'm not sure if you really get away
3 from that. But the idea by itself has some merits. It's
4 not -- you know, random ratings is not so different from
5 unsolicited ratings.
6 And of course, in the case of random ratings that
7 you're contemplating, unlike an unsolicited rating, you
8 would mandate that that chosen -- randomly chosen agency
9 have the information, so they actually could do the rating.
10 And it would be timely. Because they would get the
11 information. You say, okay, you're coming into the deal,
12 you know. We're going to also choose -- you've got to go to
13 the SEC, we're going to choose one more. And they get the
14 information the same time as the agency that was chosen.
15 And so I'm not sure the timely issue is so relevant.
16 I think though also, as I keep on emphasizing, I
17 guess you contemplate that if you chose an agency randomly
18 that you would also require that rating to do rating
19 surveillance and it wouldn't just be new issue, that they
20 have to be doing surveillance. Surveillance is important.
21 It's not just the rating at time of issue.
22 MR. FRIDSON: Yeah, it's interesting that the
23 revenue side seems to go different from the attention in the
24 marketplace. There tends I think not to be a lot of
25 controversy about new issue ratings on corporates. The

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1 question is, when they're out there, are they going to be
2 changed. And there's lots of discussion about that. So
3 it's kind of interesting that the revenue doesn't reflect t.
4 But I would just amplify a little bit on what
5 David said about the I would perhaps use the term insurgent
6 rating agencies if you go beyond Moody's, S&P and Fitch.
7 And we're all for the great American idea of competition. I
8 think the one potential downside on the random assignment is
9 an agency getting an opportunity to get a rating out there
10 and using it as an opportunity to signal to issuers, we're
11 going to consistently come in with higher ratings. So
12 again, on the cases where you're going to select someone,
13 you should be coming to us.
14 And it seems to be, in a way, at odds with the
15 whole idea of competition which has already been discussed,
16 because you're in effect saying we're going to guarantee a
17 market revenue stream to you as an agency, which seems to me
18 at variance with the notion of, well, let's beef up good,
19 solid processes here. If I know money is coming in
20 automatically, my incentive would be to cut back on expenses
21 as much as possible and clear as much profit as I can.
22 I guess the other point I think is important to
23 keep in mind here is that I don't believe you can
24 manufacture credibility through any of these processes. The
25 rating agency is going to be deemed credible, legitimate by

1 the marketplace, or it's not. Throwing ratings assignments
2 at an agency won't achieve that unless the agency on its own
3 is able to demonstrate to the market that it's a reliable
4 judge.
5 MS. McGARRITY: Yeah, that's really valuable
6 feedback. Thank you.
7 I think the idea behind it, and David, your point
8 is well taken, I think you may be very correct in that there
9 may not be enough at this point. The idea behind sort of --
10 one of the ideas behind the random assignment is to enable
11 these smaller or insurgent NRSROs to have that revenue
12 stream via the random assignment and yet still have a legacy
13 NRSRO be able to rate it, so that there is some
14 comparability and institutional knowledge there.
15 These are going to be registered NRSROs, so they
16 have to go through the criteria laid out by the SEC. So I
17 think there will be a transition period for these insurgent
18 NRSROs -- I really like that, I'm going to use that -- to
19 get their business maybe more larger. But, no, great
20 feedback. Thank you for that.
21 Do you have any suggestions for incorporating some
22 sort of performance criteria? In the working document, we
23 laid out something relatively simple just as an idea,
24 starting with basic performance disclosure and potentially
25 ultimately using performance criteria to affect the random



1 assignment. What are your thoughts on that?
2 MR. FRIDSON: Well, I guess I have one concern
3 about it. I think certainly, one way or another, rating
4 agencies like everybody in our economy should be evaluated
5 and compensated or, you know, penalized as the case may be
6 based on their performance. Measuring performance is a
7 tricky proposition even in money management, where it would
8 seem, well, this is the rate of return we earned. If you
9 study that whole field, you find there are a lot more
10 complications to it so it's not an easy process, you know,
11 even under the best of circumstances.
12 The one suggestion that was made about the
13 reporting on the number of cases where a rating changes by
14 more than X steps in one fell swoop, I think some caution is
15 required there. Because there are cases, again leaving
16 aside the structured finance, on the corporate side, there
17 are sort of, you know, what's been called event risk or just
18 major changes that occur. In the example of a company
19 deciding to do a management-led, highly leveraged buyout,
20 you know, recapitalization of the company, the rating
21 legitimately could fall from single A to let's say double B
22 in one fell swoop. That happened when the LBOs became a big
23 factor in the market not many years after the rating
24 agencies had said, well, going from A to triple B is too
25 dramatic; we better put in these gradations of plus and



1 minus or one, two, three. And no sooner had that been in
2 place was when all of a sudden you had these cataclysmic
3 changes in the credit that did warrant that. In addition to
4 cases where there was a disclosure of financial fraud. And
5 it is important to note that the rating agencies rely on
6 audited statements. They certainly make an effort to look
7 at accounting that looks suspicious. But if there's an
8 outright fraud in it, that will warrant a very dramatic
9 downgrade.
10 So I think the last thing you would want to do
11 would be to put the rating agencies in the situation where
12 they say, well, if we don't make this change which is
13 required, that's somehow going to hurt us because it's going
14 to make like we're doing -- performing poorly rather than
15 well. So again, just a little bit of a note of caution on
16 there. Although the general idea of saying, yes, I think
17 first and foremost the marketplace and perhaps, as a
18 backstop in some way, regulators being able to evaluate the
19 performance of the rating agencies has merit.
20 In the case of the financial crisis of ratings
21 falling very drastically from triple A to -- and in some
22 cases even going into default within a short period of time,
23 that I think was a function of structural problems in the
24 way the ratings were being put together and some of the
25 incentives and pressures that David spoke about.



1 MS. McGARRITY: Thank you.
2 MR. JACOB: I think that's certainly right. I
3 think what we don't have in most sectors within structured
4 finance, you don't really have event risk. There are a few.
5 It would be in CMBS when you have large loan deals or hybrid
6 deals with large loans in a pool. So remember, what a
7 mortgage-backed security is is a bunch of loans, like in
8 residential, that are put together as a big pool and it's
9 structured by creating credit enhancement in the tranches.
10 The only places I say where you have event risk
11 might be where these -- it's either a single, big, mortgage-
12 backed commercial real estate loan. So then if it's one
13 loan against one property or against an issuer, let's say
14 Simon Malls or something, those mortgages were put together
15 in a pool, then to the extent that Simon would have a
16 problem, then you could have a potential rating change.
17 Could be a fraud issue. But I don't think in general you
18 have so much event risk.
19 I think I agree with Marty, measuring performance
20 in credit ratings is a tricky thing. Just because the
21 rating is changing and going down, if the economy
22 deteriorates, of course mortgage-backed securities are going
23 to deteriorate. We'd expect that and expect the ratings to
24 change accordingly.
25 I mentioned this earlier. I think if we're trying

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1 to catch sort of the bad behavior, this issue of shopping
2 and so on, I think, like I said, maybe measuring how often
3 they change their criteria and changing the criteria in
4 response to their low market share would be a red flag for
5 me as to the rating agency really trying to solicit new
6 business. And so that's something that's a little
7 different. Because if they're changing the criteria, then
8 of course it should be reflected in their outstanding
9 ratings as well. On the surveillance side, oftentimes, it
10 isn't.
11 But in any case, the idea would be, I'm going to
12 change my criteria to get more business in response to my
13 low market share. I'm going to weaken criteria to get that
14 because now Moody's, let's say, I think right now, the
15 number you said, I think Moody's is leading S&P in
16 structured finance. And so if suddenly I saw S&P now
17 weakening their criteria in order to catch up to Moody's,
18 that would be a performance measurement to me.
19 MR. FRIDSON: Yeah. I should also add that there
20 is some performance measurement published already which
21 again would probably be difficult to replicate on the
22 structured side. But in the corporate area, to me, when I
23 made the statement earlier that I felt that the corporate
24 ratings are functioning satisfactorily, that's really based
25 on data that Moody's publishes every year showing that the

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1 default rates increase with each step down the ratings
2 scale, even at that alphanumeric level, with a slight
3 discontinuity within the single A category. But otherwise,
4 at every step down, the one year, the 10-year default rates
5 are correlated with the ratings. And I think that's
6 evidence that the system is working well, even though, as I
7 think David rightly says, you can dispute this or that
8 particular rating, which I think is a healthy thing. And
9 it's a normal thing because otherwise you would never have a
10 split rating, in other words, two agencies disagree, looking
11 at the same set of facts.
12 But I think that performance -- and Moody's, as it
13 happens, has done more of this. But I don't think, other
14 than the investment in the data work and people assigned to
15 it, other agencies could not do the same. The only question
16 being, do they have a large enough sample of issues that
17 they've rated? But Moody's also publishes things such as
18 where were the issues that defaulted at the time they
19 defaulted a year ahead. And they are overwhelmingly in the
20 CAA category, you know, a year before they default.
21 So again, I think that those kind of measures can
22 be helpful. I think because of the probably smaller sample
23 of defaulted issues, it would be inherently harder to do on
24 the structured side. But perhaps could nevertheless be
25 suggestive of approaches that might be used.

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1 And I don't know that the rating agencies -- I
2 can't speak for them, but I don't know that they would be
3 particularly averse to publishing such data, again, based on
4 Moody's having done it voluntarily for the benefit, you
5 know, the informational benefit of the investors.
6 MR. JACOB: On the structured side, they actually
7 do publish the transition tables --
8 MR. FRIDSON: Transition tables, yeah.
9 MR. JACOB: -- as well. You know, one thing we
10 don't have so much of is split ratings, especially on new
11 issue. Because what happens is, if they -- typically,
12 investors want to have the two ratings. So if there really
13 would be a split rating, the issuer tends to then go to the
14 more conservative structure -- whatever of the two, let's
15 say, rating agencies had more credit enhancement, they would
16 go to that one so that they would issue the same rating,
17 typically.
18 But we do have the transition tables. And it's
19 again the same thing, it stacks up that way, that of course
20 the lower rated ones -- look, in general, the process of
21 credit ratings is okay. You know? It's just that there are
22 these pressures that we've been talking about here.
23 I think, you know, if you really focus your work,
24 as they're changing their criteria to get -- and again,
25 that's not illegal. It's just, you know, from an investor's

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1 standpoint, that doesn't feel good because you know they're
2 moving the measuring stick. But it's not -- there's nothing
3 -- I'm not sure what you do about that, other than expose it
4 and say, yeah, they changed their criteria and now they're
5 getting the business. And that's what the press has been
6 doing lately and that's good. And investors know it and
7 they see it.
8 So, you know, again, I know you want to do
9 something here. But people are a little more sensitive to
10 it. And I think Marty mentioned this before. What happens
11 is, when everything is going hunky-dory, everyone is fine,
12 no one cares. And then when things blow up, they say it's
13 because the rating agencies were hiding the salami. Well,
14 you know, that's -- so everyone is guilty of that. Everyone
15 knows this is going on.
16 That's the funny thing about this whole meeting,
17 is it's kind of we're all intelligent adults. We all know
18 that the issuers put pressure on the rating agencies. The
19 rating agencies then try to get the business. Things go
20 along well. The economy has a problem.
21 You know, in the case of, of course, the financial
22 crisis, it was just insane in terms of the stuff that got
23 put through the system. Just on the loan side, the loans
24 that became -- that were acceptable without information, you
25 know, no-doc, loans that were, you know, 105 percent, 110

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1 percent LTV, I mean it was, you know, that was unbelievable.
2 But as a general matter, I mean, I have to say,
3 credit ratings are okay.
4 MS. McGARRITY: Thanks for that.
5 Michael, I think maybe it's time to open it up.
6 MR. HEANEY: So if I can, I first want to thank
7 both of you for making the trip down and very, very candid
8 comments. It's been incredibly helpful, I'm sure, for the
9 entire FIMSAC and certainly for the subcommittee.
10 I just want to go back to the topic of
11 surveillance versus new issue as it applies to both
12 corporate and structured. Marty, I appreciate the comments
13 made that, you know, the historicals -- the financials don't
14 matter, looking back. It's about prospectively looking
15 forward.
16 But the rating agencies do have one unique thing
17 when they meet with the company management, which is the
18 forecasts, which is the biggest issue about unsolicited
19 ratings. You can issue a rating without ever having talked
20 to senior management and have no idea what their actual
21 forecasts are for their own business, international business
22 versus domestic, whatever the case may be. And the default
23 rates -- I acknowledge, default rates by category, rating
24 category, are incredibly clean.
25 But the issue, I think, for a lot of us and I

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1 would say the SEC as a whole would be, well, what about the
2 mom and pops, the retail investors, not the sophisticated
3 investment managers, who rely on ratings, who won't know if
4 S&P's got a bad track record, to pick on them, or Moody's,
5 over the last two years. And yet they'll continue to invest
6 in what they see as single A or better, double A or better,
7 whatever the case may be.
8 So how do we tie better surveillance, knowing that
9 it's really investment losses as much as it's default rates,
10 if not more, into the mom and pop, so that they feel not
11 only more comfortable with the ratings they're getting but
12 they're actually better protected with the ratings that they
13 see when they're starting -- securities?
14 So I ask that with that whole thin layer of credit
15 rating that you talked about in structured deals. Again,
16 never having gone to the rating agencies as an issuer and
17 never worked at a rating agency, I am guessing financials,
18 corporates, are doing the exact same thing, that thin layer
19 of how do I get into the single A category. Is there a way
20 you can think of surveillance and beefing it up that David
21 talked about earlier?
22 MR. FRIDSON: Well, I guess I'm not keen on the
23 idea of the SEC getting into trying to manage the rating
24 process or deciding what ratings should be or getting to the
25 point of dictating the process.

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1 As I said, I think in that group of principals
2 that I spoke, who were hiring the agents of the managers who
3 may or may not be aligned with their interests perfectly,
4 certainly the individual investors are in that category. I
5 think that they should be aware, if they are involved in
6 buying individual issues with ratings, there are a lot of
7 things that can go wrong. You know, the rating can be right
8 and the bond can fall in price, possibly also in rating, for
9 totally idiosyncratic and unpredictable reasons. And I
10 think they, I would hope, are aware of those kinds of
11 hazards. If they're not, they will be after they get a
12 little experience with it.
13 So I think the -- you know, the other issue that
14 is probably more common would be investing in funds that are
15 using rating criteria in their issuing and their prospectus,
16 typical language, we primarily invest in speculative grade
17 double B or single B ratings and they say when we buy triple
18 Cs, it's because our analysts have determined that the issue
19 is under-rated. Or in the case of an investment grade fund,
20 there is a basket in which they can go below the investment
21 grade category.
22 I think that the -- you know, I think that there
23 are also organizations evaluating the mutual funds, looking
24 at their records. And I think that, you know, that's an
25 important consumer protection, as well. I think they're

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1 largely focused on the performance. But if there's been a
2 change in management, there could be a change in the, you
3 know, in the performance of the fund.
4 But I think if you can have reasonable confidence
5 that if you see a fund that has played it straight, not
6 abused the way they have used ratings in defining what they
7 own in the fund, and have produced a consistent performance,
8 just as in the -- in the equity mutual fund area, where you
9 don't have any of these things do deal with, you really have
10 to only rely on the management, I think you're in the same
11 boat.
12 So I guess I would just be wary of the SEC
13 attempting to assert itself too specifically in the
14 procedures for rating the issues. I think I agree with
15 David, the disclosure, publishing the criteria, giving some
16 indication that you're sticking to the criteria and then
17 looking at the results and things like the transition
18 models, I think, are very effective safeguards for the small
19 investor.
20 MR. REDFEARN: I'm going to jump in and just ask a
21 quick one here. So, David, one of the things that you
22 suggested was that, you know, the surveillance area is
23 potentially challenged because it doesn't have the same
24 funding mechanisms in part as they do in other sides of the
25 business. So I guess what's of concern also is the

1 suggestion that you were saying in structured finance, you
2 saw certain aspects of a deteriorating -- like, getting
3 worse now. And so I guess my thought on that is, you know,
4 do you have any thoughts on, you know, what specifically
5 might be able to be done to sort of discourage or, you know,
6 maybe make it so it's less likely to get worse?
7 And then, just one other quick thing is when I
8 think about the compensation models within, you know, there
9 is a little bit of a concern that compensation is based on
10 revenue, revenue is based upon business. It seems like the
11 incentives are aligned. I guess I'm wondering if, you know,
12 has there been a change in the culture at all post financial
13 crisis, whereby you've seen examples of where if somebody is
14 pushing, you know, sort of pushing the criteria too far to
15 get business, where doing ratings that potentially were too
16 high has been a negative in compensation? Where somebody
17 will say, you know, you've been pushing it too hard, that's
18 a problem and that affects comp negatively?
19 MR. JACOB: Okay, let me take this compensation
20 issue first. So I was there from 2008 until 2012. I was
21 hired and my friend who I used to work with at Nomura, Mark
22 Adelson, was hired. I ran structured finance and he ran the
23 credit analysts. The idea was supposed to be that analysts
24 shouldn't feel pressure from their own pocketbook.
25 As I said, I think the reality is that that wasn't



1 changed while I was there and it's really hard to see
2 exactly how that could change, given that that's how you get
3 paid. You know, if the firm's -- if you're area is not
4 profitable, if CDOs is making money and credit cards are
5 making money and mortgage-backed securities is not making
6 money, you're not going to get paid. Because it comes --
7 you know, they'll say it's one big pool but it's not, it's
8 just not. And I'm not sure how that really -- that gets
9 changed.
10 And to the end of the period when I was there, I
11 mean, it didn't matter -- I was already retired when I was
12 asked by S&P to join. And I'm retired now, so I really
13 don't care from a personal standpoint. I personally had
14 pressure from the president of the company at the time to
15 try to pressure Mark Adelson, who was on the criteria side,
16 to lighten up on the criteria to get more business.
17 So, from my level, I felt that's -- I probably
18 should have left the firm in 2011 already before they pushed
19 me out and they pushed Mark Adelson out, and that whole crew
20 that was there to come in and clean -- try to clean the
21 place up.
22 So in terms of compensation, I -- it's a hard one,
23 it's a really hard one. I mean, of course, you could say,
24 you know, keep it separate. And then there's less business
25 and they have fewer analysts. It's as simple as that.



1 Because if you have less business, you have to have fewer
2 analysts.
3 That becomes a problem, by the way, to get back to
4 your other question on the surveillance side. because, you
5 know, if you don't -- if you're not getting deals and you're
6 not getting revenue from the new issue side, the amount
7 that's -- they give a tail. There's a payment fee that
8 continues to come for surveillance, but it's relatively
9 small compared to the new issue. So you have to keep on a
10 big crew of analysts to -- and, remember, the deals go on
11 for a long time. They're out there.
12 So you can see that structure is tough from a
13 business standpoint, really, to keep in place. Like if you
14 only have -- suppose you tighten your criteria, you're not
15 getting any new issuance. And you have to surveil all these
16 deals that are out in the marketplace continuously. I don't
17 know if you can alter how they get their fee structure, you
18 know, that they have to -- you know, the issue has to keep
19 on paying for that surveillance. Maybe it's a bit lopsided
20 how that fee structure is done.
21 In terms of the current situation and
22 deteriorating in -- or the rating shopping that's going on,
23 I think maybe the issuers are supposed to -- should disclose
24 who they went to and who they didn't choose. Why not? Why
25 should that -- that's not -- that's not hurting them. You



1 know, it does hurt them because it looks like everyone
2 knows, you're rating shopping. And so why not make them say
3 who they went to and then didn't choose?
4 You know, I don't know, maybe some of that
5 feedback, that interaction. Remember, there's a process
6 that goes on. What happens is they come into the agency
7 with this pool and they say, how many triple As can you give
8 me, how many double As can you give me, how many single As
9 can you give me? And the analysts come back and say, well,
10 this is what it looks like. And they say, well, you know,
11 they may not say this but it does happen, of course. Well,
12 down the street, we can get half a percent more triple As,
13 you know, what do you think?
14 Again, I think you've got to have pressure on the
15 issuers a little bit. It's not fair. They're the ones who
16 are really making the money, the big money, not the credit
17 rating agencies.
18 MR. HEANEY: That's a great intro to choose Scott,
19 who is one of the issuers. But right before I do that, I
20 will say, on the subcommittee, the idea of issuers
21 disclosing who they chose during the past year and putting
22 that in the 10-K was -- I just wanted to make that point.
23 Scott.
24 MR. KROHN: Yeah, I'd like to make a few comments
25 as an issuer and respond to a few of the things that were

1 said on the panel today.
2 First though, thank you to Amy and the team. As
3 Ashley noted, it is a very complex topic. One of the things
4 that I wanted to make sure to emphasize to the group is I do
5 see a huge difference between structured finance and the
6 corporate market. So I think, you know, it might be easy to
7 try to come up with an overarching solution for both
8 markets, but I think that would be very inappropriate.
9 So just to give a little bit of background on
10 Verizon, who is a prolific issuer in both ABS and unsecured,
11 so our unsecured bond portfolio is about $100 billion.
12 Every single bond is rated by S&P, Fitch and Moody's. So an
13 assertion that there is ratings shopping going on in the IT
14 corporate market, I would completely reject, at least in the
15 IT market for corporates.
16 And as was noted, you know, the ABS market is
17 basically a triple A market, so 90 percent plus of the bonds
18 that get issued are triple A. Obviously, there is a rating
19 spectrum in the corporate market.
20 Leaving mortgages aside, I would also say that in
21 consumer ABS anyway, it's a much shorter market. So in our
22 case, the longest bond that we issue is a two and a half
23 year revolving period. Last week, we just did a 40-year
24 unsecured bond. So our weighted average life in our
25 unsecured portfolio is 13 years. Weighted average life of



1 our consumer ABS portfolio, less than two years. So that's
2 an important distinction.
3 And in terms of investor participation, I would
4 say our average ABS deal has 40 to 50 investors. Our
5 average unsecured deals will have 300, 400, 500 investors.
6 So very important to distinguish between the corporate
7 market and the ABS market.
8 With regard to the ABS market, I think as we
9 consider the ratings market structure, we also need to
10 consider a number of the Dodd-Frank reforms that were
11 implemented that have strengthened the market. For example,
12 low-level disclosure is now a requirement, not just for the
13 mortgage area and CMBS, which were the cause of the
14 financial crisis, it's a requirement for everyone.
15 Similarly, risk retention. Everyone now needs to have skin
16 in the game of any security -- that was another belts and
17 suspenders that was added to the market.
18 Lastly, in terms of -- you know, you watch the
19 movies on the subprime crisis and you see the very lax
20 documentation, et cetera, that was getting done in '08, '09.
21 There are now third party assurances, where they do random
22 sampling to make sure that every -- or a random selection of
23 loans in any given securitized pool, that actually the
24 documents match what was actually put into the pool.
25 And then lastly, 17g-5, I think, widely recognized



1 somewhat of a failure in achieving its objective of
2 increasing competition in ratings. But as an issuer, that
3 doesn't mean we can't comply. So in other words, every deal
4 we do, we have to post on a password-protected website the
5 pool. We have to contemporaneously document any discussions
6 we have with agencies so that a non-hired agency, should
7 they choose to access, has equal access to the same
8 information as a hired agency.
9 You know, I mentioned on the unsecured side that
10 all of our bonds are rated by all three big rating agencies.
11 As is the case with most best-in-practice issuers, we rotate
12 agencies on our ABS deals. But we don't rotate in order to
13 achieve higher credit enhancement to benefit from changing
14 criteria. In fact, I'd say what we do, if you look at
15 league tables, is what most of the best-in-class issuers do,
16 which is we rotate no matter what the credit enhancement is.
17 So on every one of our deals, it's either Fitch,
18 S&P or Moody's, two of those three. And so by rotating
19 amongst the big three no matter what, in effect we have
20 penalized our credit enhancement to be the lowest common
21 denominator of the three.
22 To David's point on, you know, are there maybe
23 some new platforms, some new issuers that shop credit
24 enhancement to get the best triple A outcome? That probably
25 does go on. But if we were to look at the data in coming up



1 with a recommendation to this committee, I would say the
2 vast majority of the market is rotating like we do, amongst
3 the best three, because that's what investors want. And at
4 the end of the day, you get rewarded over the long term by
5 proving that you're not rating shopping by actually using
6 agencies in your rotation, no matter what.
7 So, you know, I think that's something if we are
8 to make a recommendation, we should really look at the data
9 as to, you know, who is rotating agencies, kind of no matter
10 what the enhancement outcome, versus who is basically rating
11 shopping to get the best credit enhancement.
12 You know, unfortunately, I think for the proposal
13 as it's presently scoped, you know, the agencies that are
14 giving the best credit enhancement are probably the ones
15 that would be pushed towards using as a part of a random
16 assignment process. A new issuer, if they had their
17 druthers, would have S&P, Fitch or Moody's on the deal. And
18 a lot of times, debut asset classes will come to the market
19 without one of those, in order to get the better credit
20 enhancement.
21 So I think, again, before recommendations are made
22 on this front, we should be looking at that sort of data.
23 MR. JACOB: I'd just like to make a point. I
24 think you are absolutely -- I think you are saying what I'm
25 saying, is the -- and you're doing a great job in that if

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1 you're using the rotation, because you are using all of
2 them.
3 So again, you know, part of the recommendation
4 maybe should be, you know, what behaviors can we have on the
5 issuer side that are good behaviors to then not -- the
6 rating agencies don't feel that pressure. And this would
7 be, you know, definitely a positive for the marketplace,
8 that the issuers feel that they also have this. And I
9 think, obviously, having a lower tranche, having, as you
10 said, skin in the game is definitely a positive.
11 I am aware of the posting of the information.
12 It's still difficult with that posted information to
13 actually do an unsolicited rating. And I don't think -- I
14 don't know if anyone is here -- again, I am not in the
15 marketplace anymore. But I don't think there have been any
16 unsolicited ratings. Have there?
17 MR. KROHN: No, because of the 10 percent
18 requirement, et cetera, it's a requirement that market
19 participants have to abide by. But really, it's not
20 resulting in any unsolicited ratings.
21 MR. JACOB: Right. I don't think it's sufficient
22 information. But I don't think there have been any
23 unsolicited rating in the structured finance arena. And
24 again, it could be for a couple of reasons. One is the
25 resource issue; they're not going to get paid for it. But,

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1 you know, if it's enhancing the reputation with investors,
2 that's one way you get paid.
3 But I also think the information may not be there
4 on a new issue basis and an ongoing basis. But a good
5 balance between paying attention to what the rating agency
6 is doing and what the issuers are doing I think would be a
7 fair way of going.
8 MR. KROHN: And just one other follow-up to an
9 earlier comment. If you are following SEC rules and you
10 hire an agency and you don't use that agency because the
11 credit enhancement is what you like, that should be
12 disclosed in your prospectus.
13 MR. JACOB: That's if you hire them and you don't
14 use them.
15 MR. KROHN: And you don't use them.
16 MR. JACOB: Yeah, but that's how it goes on in
17 structured. What goes on in structured is you get
18 preliminary feedback and you don't hire them. That's the
19 problem.
20 MR. KROHN: In theory, the agencies aren't
21 supposed to engage without being hired.
22 MR. JACOB: Yeah.
23 MR. HEANEY: I would just make one comment, and I
24 completely agree. Great thoughts and great feedback.
25 The tricky thing is the best-in-class issuers

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1 versus those that cut school. So how do we think about
2 those issuers, the high-yield issuer, totally different from
3 investment grade, choose one rating agency, don't rotate,
4 what the impact to investors could be versus Verizon and how
5 it operates. So I -- I grant there is definitely a best in
6 class and there is a massive difference between structured
7 within the products, investment grade, high yield. Which is
8 why this is -- I think Brett's expression was a thorny
9 issue. This is a tricky issue, for sure.
10 MR. FRIDSON: If I could interject, the minimum
11 two ratings has become pretty well established in the high-
12 yield market at this point, and that has been an evolution
13 over time. So I think that's been a positive effect.
14 But the other difference, in this case in Verizon,
15 they are coming back to market frequently so that, in
16 effect, it has the same effect as surveillance. Because if
17 they were to rate a new pari passu issue lower than the
18 previous issues, they would have to rate the other issues
19 lower, too.
20 So another dividing line is the essentially one-
21 time issuer, which you do see in the high-yield market, who
22 is not only not going to pay for surveillance but doesn't
23 care what happens in the aftermarket. And I've even heard
24 investment bankers reflect that. You know, I remember a
25 case where I commented to an investment banker that the

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1 investors were unhappy because, shortly after the issue came
2 to market, it had been downgraded severely because of a
3 leveraging up by the company. And the response of the
4 investment banker, I think in all sincerity was, what are
5 people complaining about? We're still paying the interest.
6 You know, with no awareness that there was a secondary
7 market for the bonds because, you know, they got paid when
8 it came out and it was not their concern. Maybe the trading
9 desk was concerned about how it traded but the investment
10 banker was not.
11 So I think that, yes, things tend to work pretty
12 smoothly for issuers who come back to market frequently,
13 don't want to burden the market in that way. But the one-
14 time company out there, private equity firm that's bought
15 it, they are going to pay themselves a huge dividend,
16 monetize, get out and leave maybe an empty bag for whoever
17 comes next. That's where the problems will tend to arise.
18 MR. HEANEY: Larry.
19 MR. HARRIS: David, I want to thank you for your
20 very articulate explanation of the problem that faces us,
21 and also for your candor on the personal story that you
22 offered. It's clear that we have a slippery slope here and
23 now the question is how do we create incentives to provide
24 more balanced information.
25 There are three different ways, I think, that we

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1 can do this. There's the regulatory approach, which is what
2 the SEC has largely adopted since Sarbanes-Oxley and Dodd-
3 Frank, which is to provide more oversight, more structure to
4 give a sense that the government is watching.
5 There are assignment and funding approaches that
6 were put up in the whitepaper that was presented for our
7 discussion today. As both Martin and David note,
8 performance evaluation is essential if we are going to go
9 this route. And it's very difficult. The transition
10 probabilities and stuff like that and the relationship
11 between default rates and credit ratings provide useful data
12 but those are data that are collected over 40 or 50 years
13 and simply are not adequate to manage an assignment process.
14 Funding mechanisms have been explored for ages and
15 they are very difficult. We could talk more about it.
16 Martin suggested that the ultimate discipline on
17 the rating process is market acceptance. And I wanted to
18 ask both of you what we can do to give the market more of a
19 voice over the quality of the ratings? And in particular, I
20 would like to suggest a specific mechanism, but I am open to
21 other mechanisms.
22 So the mechanism that I would like to suggest was
23 brought to my attention by a fellow named Ken Winston who
24 used to be the chief risk manager for Western Asset. And I
25 regret that I wasn't aware of this mechanism earlier because

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1 I think it's very clever. But there may be other clever
2 mechanisms as well. My regret is that I would have wanted
3 to introduce this earlier.
4 So his suggestion, and I want to put my voice
5 behind it as well -- but again, I'm hoping for other
6 mechanisms as well -- he suggested just like we ask
7 shareholders to ratify the appointment of the independent
8 auditor, perhaps we should also ask the bondholders to
9 ratify the selection of one or even more bond rating
10 agencies, so that perhaps once every year or once every two
11 years, the bondholders get to provide a vote on whether they
12 are pleased, you can use the word ratify or whatever, with
13 the rating agency that was chosen by the issuer. It could
14 be multiple rating agencies. And maybe even as infrequently
15 as once every three years.
16 We know that these votes will probably almost
17 always be 100 percent. But every now and then, if they're
18 not, then that will be a serious problem for the rating
19 agency. Because after all, the rating agencies base their
20 business on reputation. So the hope here is that through a
21 mechanism like this or other mechanisms, that we might be
22 able to give the ultimate user of these ratings a stronger
23 voice so that they can exercise more market discipline.
24 So the question is, can you think -- can you see
25 an upside or a downside to this proposal or any other

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1 similar proposal that might give the bondholders a greater
2 voice over the quality? And if this voice would -- and
3 would this voice actually act to move the ratings in the
4 right direction? Not the ratings but the incentives. Would
5 it move it in the right direction or potentially do harm?
6 MR. FRIDSON: Well, that is a new idea to me. So
7 I need to think about it a little bit more for the
8 ramifications. But I would say that, you know, on
9 principle, you know, the idea makes sense to say, yeah, give
10 a voice to the users.
11 Again, the -- but the people you're talking about
12 -- well, if you're talking about the bondholders, are you
13 talking about the ultimate agent, you know, the owner of the
14 bond? More likely, we're talking about the mutual fund or
15 asset manager. And, of course, the bonds are actually held
16 in the name of that agent in many cases. And again, those
17 interests are not necessarily perfectly aligned with those
18 of the ultimate investor. So I think that would be an issue
19 that would have to be explored.
20 I should say, one mechanism that already exists at
21 Standard and Poor's is a group that meets periodically of
22 investors -- well, money managers, who meet with the ratings
23 people at Standard and Poor's and discuss the policies and,
24 you know, the outcomes of the ratings. Various issues come
25 up because there are new factors coming into the ratings

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1 that get onto that agenda. And I think that's a useful
2 process. It's not as formal or, you know, has quite the
3 same effect as you describe. But it is providing input.
4 One point that's useful to keep in mind in that
5 input is that the rating agencies have said that they could
6 make the ratings more dynamic than they are. It would be a
7 simple thing to say, well, the economy is doing a little
8 better, let's lower it, raise the rating, lower it because
9 the rating is doing a little worse. And part of this
10 feedback process, and not necessarily specifically through
11 this series of meetings, but in general the investors or the
12 money managers say, no, we don't want you to do that; we
13 want the ratings to be more static unless there is clearly a
14 long-term deterioration.
15 So you will hear criticism, oh well, gee, the
16 market has in effect downgraded it because the things are
17 going poorly but the rating agency must be asleep because
18 the rating hasn't changed. Well, again, it would be a
19 simple thing to engineer to make them more volatile. But
20 the managers say, well, you downgrade it, we are forced to
21 sell it because of the criteria we have that limit our
22 rating categories and then we buy it back a year later.
23 Well, all that's happened is we've lost money on that
24 purchase and sale, we would have been better off if you had
25 just left it where it was.

1 So it's not necessarily self-evident of where this
2 kind of process will be and what the votes in the process
3 you describe will be directed toward. But I think it's
4 certainly worth further investigation.
5 MR. HARRIS: David?
6 MR. JACOB: Just thinking about it here, I've had
7 more time than Marty to think about it because he answered
8 first.
9 My gut reaction is, sure, it's positive to have
10 that kind of voice. And also, more, it's probably good
11 because afterwards the investor can't come back and say,
12 well, blame it on the rating agency because, well, they said
13 it was okay. Because that is generally the pattern, right?
14 When things go bad, you go blame the rating agency.
15 So if they said, well, we are happy with what
16 they're doing, then that's probably a good thing because now
17 it's very hard to come back afterward and say, well, now
18 we're not happy with what they're doing, just because things
19 went awry. I think Marty's right.
20 But I think the rating agencies claim that they
21 rate through the cycle. That's a claim. Somehow, the
22 rating is meant to go through the economic cycle as opposed
23 to we're going to upgrade, downgrade, as things get weaker
24 and stronger. And I agree --
25 MR. FRIDSON: Well, again, that has varied over



1 time. I think you don't hear that term used as much as it
2 once was. That was the idea when I first started in the
3 business. Yes, they said, yes, we rate through the cycle.
4 I think, particularly for the speculative grade issues, they
5 feel that that's not as good a policy to follow.
6 But again, they do maintain more stable ratings
7 than -- again, the market can upgrade or downgrade, in
8 effect, by the pricing on a daily or intraday basis. The
9 rating agencies wouldn't go as far as that on a day by day,
10 but they could more frequently change the ratings.
11 Clearly, in a recession, default risk in general
12 rises. The question is what should the rating mean. And,
13 you know, in general, they tend to stay with it unless they
14 feel there has been a fundamental change in the rating. But
15 it's expected that the earnings, cash flows of the company
16 are going to be up and down over the cycle.
17 MR. JACOB: Also, in structured, as mentioned,
18 this is mostly the triple A market. Let's be clear. And
19 so, of course, in triple As, there's much -- should be much
20 less volatility in the rating, even through a cycle. But
21 the reason why we're all here, again, is it was so sensitive
22 to the marketplace about getting triple As that went down
23 and went down hard and fast. And this is, you know, when
24 someone who buys a speculative grade bond, they know -- I
25 mean, they should know what they're doing because it's a



1 speculative grade bond. They expect volatility and they
2 expect to lose on some and not lose on others.
3 In the triple A rated bonds, people want to buy
4 them and not think about the credit rating. And the bulk of
5 the triple A, double A market, remains structured finance.
6 I agree with you, in terms of credit cards and asset backed,
7 it's very short. It always comes back to the same area,
8 which is the mortgage-backed market. A little bit in the
9 CDOs, but even there, people I think have a better handle on
10 CDOs and CLOs.
11 So as you focus this thing, think about the
12 residential mortgage market which, you know, has its issues
13 and you need to look there on the loan side. If loans are
14 getting riskier, we know what's going to happen. And on the
15 commercial real estate side, it is more exposed to the
16 cycle. It can be more concentrated. And it's a place
17 where, despite disclosure the way it is today, you can't --
18 you need a lot of information to really, really evaluate
19 those loans, especially when they are larger sized loans.
20 So but I think having the investors on board, I
21 mean, I used to hold meetings with investors. And some of
22 them complained that we were -- S&P had moved too much,
23 being at that point in the market after the crisis, had
24 gotten too conservative. And they were complaining. They
25 wanted S&P on the deals. And they also complained, just



1 like the issuers were complaining to me, I had investors
2 complaining to me. Because they wanted to have S&P on the
3 deal, just because they needed to have the two rating
4 agencies.
5 So having them, their voice and saying, yeah, we
6 like what you're doing, my gut reaction is it's a good
7 thing.
8 MR. HEANEY: Unfortunately, I am going to have to
9 cut this off. We are already into the time for our next
10 topic.
11 I want to thank Marty and David very much for
12 coming down, spending the time. It was an incredibly
13 insightful discussion, as I said earlier.
14 Amy, thank you for leading it and for your
15 leadership on the subcommittee. Again, this is an important
16 topic, one that I'm sure we will engage in again at the
17 subcommittee level. We've got a host of bullet points and
18 topics to address that were brought up today. So again,
19 thank you and thanks to everyone for your participation.
20 We will take a very short five-minute break and
21 then we'll be back.
22 (Recess.)
23 MR. HEANEY: Why don't we get started here?
24 DRAFT TECHNOLOGY AND ELECTRONIC TRADING RECOMMENDATION
25 TO ENHANCE DATA REPORTED TO TRACE

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1 MR. HEANEY: For the second panel, we will
2 consider the recommendation from the technology and
3 electronic trading subcommittee on enhancing the data that's
4 reported to TRACE for certain portfolio trades and spread
5 trades awaiting a treasury spot.
6 I will now turn it over to Sonali Theisen to
7 summarize the preliminary recommendation for us and moderate
8 the panel.
9 MS. THEISEN: Wonderful. Thank you, Michael, and
10 thank you to the Commission for the invitation today to
11 moderate this panel. I will just begin with a couple of
12 opening remarks before moving to our panelists.
13 Over the past two decades, TRACE transaction
14 reporting has meaningfully changed the transparency
15 framework for corporate bonds as well as other bond markets.
16 Thanks to this important rulemaking by the SEC and FINRA
17 many years ago, market participants have come to rely
18 heavily on TRACE data for all aspects of investment
19 analysis, risk management and trading.
20 Given the critical importance of TRACE to the
21 marketplace, FIMSAC has engaged in many deliberations about
22 potential ways to further enhance TRACE to provide more
23 detail or reflect evolving market dynamics. As we enter the
24 last year of our charter, FIMSAC members believe it is
25 important to continue discussing aspects of TRACE that may

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1 be worthy of review.
2 Our panel discussion and preliminary
3 recommendation today investigate instances that TRACE data
4 dissemination may benefit from further definition or
5 clarity. In devising this recommendation, our
6 subcommittee's objective was to identify features of certain
7 reported transactions that may be important for public for
8 trading or analytical purposes.
9 As we know, TRACE is relied upon heavily by the
10 markets for timely transparency, which can help inform
11 investment decisions. TRACE is also foundational to
12 academic research on matters such as liquidity positioning,
13 capital allocation and transaction costs. It is therefore
14 important to our subcommittee to consider ways to help all
15 types of market participants in their efforts to further
16 dimentionalize and filter TRACE data.
17 As you will hear during our panel, our
18 subcommittee identified two types of transactions that may
19 contribute to confusion or create noise on TRACE. The first
20 is the longstanding practice of investment grade bonds being
21 traded with a delayed treasury spot. And the second is the
22 relatively new practice of portfolio trading which, of
23 course, first needed definition by our subcommittee.
24 Our subcommittee also examined the growth of
25 electronic trading and debated whether it would be in the

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1 public interest to more easily identify electronic trades to
2 more accurately monitor this trend.
3 Our subcommittee extensively researched today's
4 recommendation together, as well as with the input of
5 subject matter experts from the industry. Given that the
6 delayed spotting protocol and portfolio trading both occur
7 predominantly in institutional markets, in this instance the
8 subcommittee sought feedback from institutional participants
9 only.
10 I would also like to note that today's subject
11 matter has been discussed in at least two of our FIMSAC
12 subcommittees. Initially, by the corporate bond
13 transparency subcommittee chaired by Mihir Worah and
14 subsequently by the e-trading and technology subcommittee
15 chaired by Rick McVey. It was determined with the
16 Commission that this topic could reasonably be addressed by
17 either subcommittee.
18 And so while the recommendation that we put
19 forward today was put forward today by the e-trading and
20 technology subcommittee, I believe it incorporates
21 discussions that had previously taken place in the
22 transparency subcommittees as well. It also seemed
23 appropriate to tackle this topic within the e-trading and
24 technology subcommittee, given the general dependence on
25 technology for the recommendation put forth. And, in the

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1 case of delayed spotting, the high usage of trading venues
2 to effect those types of transactions.
3 On a personal note, this has been a topic that I
4 have been passionate about exploring for many years. So I
5 would really like to thank Rick and the Commission for the
6 opportunity to moderate today's discussion.
7 And with that, I would like to start by
8 introducing our esteemed subject matter experts and begin
9 today's panel.
10 First, our FIMSAC committee members that are
11 joining us on today's panel are Horace Carter, who is also a
12 subcommittee member of the e-trading and technology
13 committee. He is head of fixed income trading at Raymond
14 James. We also have Lynn Martin on FIMSAC, president of ICE
15 Data Services. Lynn also chairs the municipal transparency
16 subcommittee. Joining us from FINRA, we have Ola Persson,
17 head of transparency services. And joining us from
18 Vanguard, we have Josh Barrickman, head of fixed income
19 trading at Vanguard.
20 So with that, I will start with the topic of
21 delayed spotting. And Horace, perhaps I can begin with you.
22 If you could go through the process and first just explain
23 what we mean when we say that in typical investment bond
24 trading, there's a trading convention known as delayed
25 spotting, and also just what the various trading conventions

1 are within investment grade bonds, particularly as it
2 relates to the institutional market.
3 MR. CARTER: Sure, Sonali. Thanks.
4 So investment grade bonds, as opposed to high
5 yield bonds, which trade on a dollar price as a percentage
6 of par, trade on a spread, which is generally quoted in
7 basis points. And so if I were a trader and I said that I
8 will sell you these bonds at plus 50 to the three year, that
9 means that I would sell it to you at a one half percent
10 higher yield or return than the three-year treasury at that
11 time.
12 When Sonali refers to the 3:00 p.m. spotting, that
13 means that you agree to the spread, the 50 basis points, at
14 an earlier time and then you do the trade at the 3:00
15 Eastern futures close. And so that is a common practice
16 within the industry.
17 The important thing to remember about the -- the
18 important aspect to the market convention that we're
19 describing is to understand that the price action in
20 investment grade corporate bonds is relative. And so it's
21 the movement of the spread, not necessarily the movement of
22 the price, which generally tracks treasuries. That's
23 important.
24 MS. THEISEN: Thank you, Horace. And can you also
25 elaborate, is this predominantly done in institutional



1 markets? Do we also see this in retail? How often do we
2 see the practice of quoting on spread versus on price?
3 MR. CARTER: So in terms of retail clients, we do
4 not quote on spread. It's purely institutional. But retail
5 or private client trading desks operate on spread. And so
6 and then -- because you have two types of investors
7 essentially in investment grade bonds. Those are relative
8 value investors, something like a hedge fund, for example,
9 and then yield investors or real money. A private client
10 would be an example of that.
11 MS. THEISEN: Thank you.
12 Josh, if I could turn it over to you, once a bond
13 is quoted on spread in the institutional markets, can you
14 please describe in more detail crossing versus spotting?
15 And also give some context to the frequency or rationale of
16 a trade being spotted, particularly within, say, the ETF or
17 index fund management community. What is the reason that
18 those trades may get spotted later in the day and at what
19 time would that typically occur?
20 MR. BARRICKMAN: Sure. I'll just start by saying
21 thank you for the opportunity to contribute to the
22 committee's work here.
23 So spotting is really the convention in the
24 marketplace, or crossing. You know, in the spotting
25 example, you are agreeing to that spread. And then at some



1 point, you are going to agree to the price of the treasury
2 and the combination of those two will give you a price. The
3 difference between crossing and spotting is that, so in
4 Horace's example, you traded 50 basis points relative to a
5 three-year treasury. You -- if I'm a purchaser of the
6 corporate bond, we actually would cross and I would purchase
7 the corporate bond and sell the three-year treasury to my
8 counterparty. So it is just a little different way of
9 setting that risk.
10 The instance of delayed spotting is, generally for
11 us, 4:00 is probably the most relevant time for our cash
12 flow investing. So if we get money into a fund, let's say
13 $10 million, it's going to be valued at that night's NAV at
14 4:00. So what we'll want to do is make sure we set all of
15 our interest rate risk at 4:00 to match up with when that
16 subscription or redemption, frankly, comes in or out of the
17 fund.
18 So the reason that you don't -- and I guess just
19 to set the stage, thinking really about a corporate fund or
20 some fund that owns, you know, spread product, the reason
21 you don't just buy everything at that 3:00 or 4:00 is
22 because the market is just not that liquid. Or it's not
23 perfectly liquid. It's over the counter. You spend a lot
24 of time with liquidity discovery, price discovery.
25 So, you know, the traders on my team are going to



1 start looking at that inflow at 10:00, 11:00, 12:00,
2 whatever it might be, go out, find the bonds that they want
3 to source, agree on those spreads. So we've locked in the
4 spread at that point. But we haven't locked in the interest
5 rate risk. So, you know, interest rate risk relative to
6 spread risk is much higher, so we want to make sure that we
7 align that with the pricing of the fund.
8 So we've gone to, let's say, three, four, five
9 different counterparties agreed on spread but also said,
10 okay, at 4:00, I'm going to call you back up and we're going
11 to spot. So by doing that, we align all of our risk to the
12 4:00 pricing time.
13 If conversely we said we did these trades middle
14 of the day, but we crossed, so we could do that and we could
15 take interest rate risk off the table by using futures or
16 using cash treasuries. But then when we get to the 4:00
17 pricing time, we have to reverse that trade. So we've just
18 done a round trip of transactions costs. So that's really
19 the motivating factor, saying, I want to agree now because I
20 need time to find bonds to discover liquidity, but I don't
21 want to take the risk until that 4:00 snapshot.
22 MS. THEISEN: Great, thank you. And maybe Ola,
23 you would be able to perhaps give us some context to whether
24 empirically you see evidence of this type of behavior within
25 TRACE and what your observations are there?

1 MR. PERSSON: And again, same as Josh, thank you
2 very much for inviting me and having me here.
3 So, yes, you can definitely observe this behavior
4 in the data, if you start on the macro level. And this is
5 clearly something that you see in customer transactions in
6 investment grade bonds. That's where it's very prominent.
7 If you look -- if you divide the trading day into
8 15-minute intervals, you typically see around 2, 2 and a
9 half percent of trades and volume come through in a given
10 15-minute period throughout the day. At the 3:00 to 3:15
11 window, we see about in total about 7 percent of trades and
12 volume come through. But there's a much higher
13 concentration in larger transaction sizes, 100,000 to a
14 million, it's 11 percent of the day's trades and volume come
15 through, 1 to 5 million, it's about 9 percent; over five,
16 it's about six. So it's definitely -- I the data
17 illustrates what Horace and Josh were describing.
18 Of the trades that come through at that time, I
19 want to stress that's also a 15-minute window. But the
20 institutional size trades, it's 70 percent of those
21 transactions in that 15-minute window -- trade execution
22 time, which I think would illustrate --
23 So it's very evident that the market practice the
24 way it's described seems to play out in the data.
25 You do see also a little bit of a bump at 4:00



1 p.m., but to a much lesser extent and almost exclusively in
2 the larger transactions, not so much in smaller transaction
3 sizes.
4 If we see this recommendation adopted, a back-of-
5 the-envelope calculation, I think we would see maybe a
6 thousand trades a day customer investment grade trades per
7 day coming through with a --
8 MS. THEISEN: Great, thank you, Ola.
9 Lynn, from a data perspective, what are your
10 observations? Do you have information you could add to the
11 discussion?
12 MS. MARTIN: Yeah, thank you, Sonali, for inviting
13 me to participate. Rick, as well, and the SEC.
14 So when this recommendation got put forth in draft
15 form and we were talking about this topic, I actually asked
16 our data science team to take a look and see what they saw
17 from the data vendor perspective with the incoming prints on
18 TRACE. And what we looked at is over the last four years,
19 we noticed that the amount of trades reported at 2:59 hadn't
20 really moved. Same things with 3:01, haven't really moved.
21 However, at 3:00, it moved from in 2016 being half a percent
22 of the market to now almost 4 percent of the market, so
23 that's what we're seeing on the incoming side.
24 I think the main thing from a data vendor
25 perspective is not just about the 3:00 p.m., 4:00 p.m., the



1 end-of-day print. But increasingly in fixed income, you
2 have more realtime services available, best execution, TCA
3 tools. We have a realtime pricing service called continuous
4 evaluated pricing. So from our perspective, knowing that
5 there is information, knowing that there are trades that are
6 happening throughout the course of the day as the
7 recommendation proposed, eliminate some of the noise and
8 just gives us more data that we can coalesce and utilize
9 with our other data that we receive to give more
10 transparency to the market throughout the course of the
11 trading day.
12 MS. THEISEN: That's very helpful. Thank you,
13 Lynn.
14 And I think, Horace, maybe I could turn over to
15 you now, now that we have a bit of background and context on
16 what the practice is, a 3:00 p.m. spot and the data that Ola
17 and Lynn have shared on the observations. Could you please
18 describe our subcommittee recommendation in a bit more
19 detail with respect to delayed spot trades and also what
20 other measures we considered in evaluating and ultimately
21 putting forward this recommendation?
22 MR. CARTER: Sure. So the recommendation that we
23 have actually come up with is two parts. So first is to
24 include on all trades that are done at a late day spot,
25 either 3:00 or 4:00, have an indicator, indicating that the



1 spread at which the trade was executed was determined
2 earlier in the day. And then the second part is to also
3 include the time of day that the -- that the spread was
4 determined.
5 The subcommittee considered a pretty wide variety
6 of potential options for different proposals we might make.
7 The first and most robust was to -- was to require what
8 amounts to a slate for a trading system. So you would have
9 -- you would put in a trade that included the spread and
10 then that -- that would report at the time with volume and
11 spread to TRACE and then the price would populate at the
12 spot time.
13 And after a lot -- obviously, you get some
14 benefits from that, including you get to follow volume
15 through the course of the day. I mean, it would be a
16 meaningful enhancement. But as we considered it and what
17 the operational lift would be, from a cost/benefit
18 standpoint, we just really didn't think that it would -- you
19 know, the juice wasn't worth the squeeze, so to speak.
20 And so the second thing we considered was
21 requiring the spread be put on the trade, so that a new
22 field including the spread. And we generally -- we kicked
23 that around for a while. But since most of the trades are
24 done very close to 3:00, per Lynn's data that she just
25 shared, the price at which the trade is executed is close

1 enough to the treasury where it would only be a marginal
2 improvement in the information to actually post the exact
3 spread. Because TRACE actually calculates a spread based on
4 the treasury at the time.
5 You could also have some confusion because,
6 depending on what the maturity of the bond is, not every --
7 not everybody is using the same benchmark. And so if I post
8 a spread to the 10 year or the seven year, how do I know?
9 And that can be confusing. So we felt like ultimately, this
10 proposal, albeit fairly modest, is sufficient for the back
11 testing and market analysis improvements that we were after.
12 MS. THEISEN: Right, if I can add to that, I
13 think, as well, Lynn, correct us if you disagree. But by
14 having the initial time stamp of when the trade was
15 executed, we propose that that would give the marketplace an
16 ability to go back and calculate the spread at the time, and
17 to the extent that that had moved throughout the day, it
18 should hopefully eliminate some of the noise as we discussed
19 in data, even if that's post fact.
20 I also would kind of add to Horace's comments
21 around reporting the spread versus the price only. We did
22 think that there was a benefit to the market actually
23 knowing the spread in institutional markets and that being
24 explicitly given. One of the obstacles that we felt that we
25 faced was again this kind of reopening of the same ticket



1 later in the day, and that that might be something for the
2 Commission and FINRA to consider at a later date as a phase
3 two, but that this would be a good starting -- a good
4 starting point for the discussion.
5 We also thought that if we reported the spread
6 just on delayed spot trades, we would create an
7 inconsistency with trades that are not delayed spot and
8 happen throughout the day, i.e., you would only have the
9 spread on trades that had been delayed through the day. So
10 we did not want to create any inconsistencies in the TRACE
11 tape for all transactions. So I think that was -- again,
12 there was a lot of robust discussion around the proposal and
13 I do think that we felt within the subcommittee that it
14 would be worthwhile for the spread to be known to the
15 marketplace at an earlier time but that that might be a good
16 subsequent discussion for us to have. I don't know, Lynn or
17 anyone, if you have thoughts on that point.
18 MS. MARTIN: No, I mean, I completely -- I
19 completely agree. I think the recommendation does increase
20 transparency in the markets, not just from a realtime
21 perspective, from an end-of-day perspective. But if you
22 think about all the analytics that are increasingly becoming
23 important in the fixed income markets, the TCA, transaction
24 cost analysis tools, best execution liquidity metrics, by
25 having more data available at closer to the time of



1 execution, it allows the vendors and market participants to
2 just have a higher quality service and more effectively
3 manage risk throughout the course of the day.
4 MS. MARTIN: That's great.
5 MR. CARTER: Just to clarify sort of why this is
6 important for people, from a practical standpoint, what
7 happens is spreads move over the course of the day. And
8 then trades print at 3:00 that indicate a spread where bonds
9 may have been trading earlier. And so if spreads have
10 widened out by, say, five basis points, which in a market,
11 institutional investment grade corporate bonds trade in one,
12 two, three basis point markets at the most. So if you have
13 a five basis point move over the course of the day, that's
14 meaningful.
15 Well, it creates noise at the end of the day if
16 people are trying to execute trades and they'll say, hey,
17 trader, the bonds are supposed to be here, this is where
18 they're trading. No, that trade was from earlier. And that
19 creates friction, that creates inefficiency. And we think
20 that applying that price and showing the trade earlier in
21 the day will clean that up.
22 MS. THEISEN: Terrific. Thank you, Horace.
23 Ola, if I could come back to you for a moment?
24 Given the proposal, the recommendation as it's currently
25 drafted, could you talk to us a bit about what you think



1 would be the, you know, anticipated cost or process for
2 implementing this recommendation? What would be the
3 operational lift? What types of market participants would
4 be required to make changes?
5 MR. PERSSON: Yeah, absolutely. So, yeah, this is
6 -- phase two, as you described it, would be order of
7 magnitude more complex. This is a relatively -- impact of
8 implementation like this. It's very similar to an equity
9 concept, the prior reference price, it works very similarly.
10 So generally, from our perspective, we would add a
11 value to a modifier field that exists and we would add a new
12 time stamp field. And if somebody selects the modifier that
13 would have to populate the time stamp to -- time of the
14 spread.
15 So if you look at it from our perspective, in our
16 perspective first, we obviously need to update our trade
17 interfaces, whether it's to fix specifications to trade
18 management screens, upload functionality, not terribly
19 complicated. Again, the complexity here isn't that great.
20 We would also need to obviously look at downstream
21 systems and update our compliance tools, trade journals, et
22 cetera. But those are normal things we have to do with any
23 implementation.
24 In terms of other participants, obviously the
25 FINRA members would need to make sure they code their

1 systems to provide this information to us according to the
2 definition. We would also add this to the outbound -- to
3 the data feeds. So anybody who consumes our data feeds
4 would need to update their interface to us to accommodate
5 that and take that in.
6 So the -- so, generally speaking, the impact on us
7 would be relatively limited. I'll let Horace speak to the
8 FINRA member side and maybe Lynn to the data side.
9 But things that sometimes we need to keep an eye
10 on, I don't think we need to solve it today, but things like
11 validations, what are the rules around this field can add a
12 little bit of complexity. For example, would we only allow
13 this time stamp to look back same day, would we allow it to
14 look back multiple days? Again, we don't have to solve
15 those issues now but those are the kind of questions we're
16 going to have to ask along the way.
17 MS. THEISEN: Thank you. Horace, would you have
18 some thoughts for us on what you think this may -- I assume,
19 Lynn, that this would be, you know, from a resourcing
20 perspective, quite easy --
21 MS. MARTIN: Yeah, it's a very easy lift from a
22 data vendor perspective, because we already take the TRACE
23 feed. If it's another field, it's just another field we
24 consume. So --
25 MS. THEISEN: Thank you. Horace, maybe you could



1 talk to us from the dealer perspective. Is this a light,
2 medium or heavy lift? What are any of the complexities or
3 challenges or sensitivities? And then maybe after that,
4 Josh, as well, if you could think of any other -- from both
5 of your perspectives, any market participants that would be
6 sensitive or, you know, concerned by this type of proposal?
7 MR. CARTER: Sure. So in terms of the cost of
8 implementation from the dealer perspective, I just don't
9 think it's a very heavy lift. I'm quite sensitive to the
10 obligations that we place on our traders in terms of
11 fulfilling the regulatory reporting requirements and all
12 that. Because every time that they have to do that, that
13 keeps them from trading and that creates inefficiencies and
14 so on. But this is pretty modest from that perspective.
15 I did speak to some of our order management system
16 people and asked them what the requirements would be.
17 Moderately more than on the actual trading desk. And it
18 depends a lot. When I was talking to them, the word I heard
19 a lot was, "depends." Well, it depends on what they do.
20 And one of the things on which it depends most is how many
21 different systems your order management system is tied into.
22 Because they're all going to have to reflect the same thing.
23 So it could be significant. But my overall
24 impression was that not -- not enormous, from our side.
25 MS. THEISEN: Okay. Josh? And also, I would be



1 curious to know, Josh, if you think, you know, many of these
2 trades are already done electronically and thereby, you
3 know, the lift on your side versus a platform, do you think
4 that you will have to make a lot of changes internally? Or
5 do you think much of that will kind of get taken care of for
6 you by the marketplace and other participants?
7 MR. BARRICKMAN: Yeah, absolutely. I don't think
8 it's much of a lift at all for us. You know, in thinking
9 through the proposal, I really don't see any downsides. On
10 the upside, it gives us a much cleaner TCA when we get to
11 the end of the day and we're comparing trades, and just
12 removes some of the noise that might, you know, cause you to
13 -- push you into trades or stop you from trading because
14 you're trying to interpret data that is, you know, three or
15 four hours old and the market has moved. So, yeah, it
16 doesn't really feel like a burden on the buy side.
17 MS. THEISEN: Great, great. Thank you very much.
18 I think those are very helpful comments to help kind of, you
19 know, unpack this topic.
20 And I would like to now turn our attention to the
21 topic of portfolio trading. So, unlike 3:00 p.m. spotting
22 or delayed spotting, which has been, you know, a
23 longstanding convention in the marketplace, I think that,
24 you know, portfolio trading, and we'll get into how we have
25 recommended defining it, but the portfolio trading that we



1 are describing in today's recommendation is a relatively new
2 phenomenon and one that we think currently is predominantly
3 seen in the corporate bond markets. And that's not to say
4 that it could not expand going forward into other bond
5 markets and other asset classes more generally. But we do
6 think that, unlike the delayed spot recommendation, that
7 portfolio trading is, you know, an opportunity for us to
8 consider a protocol that has been evolving and changing very
9 recently in the marketplace.
10 You know, I would like to just start by making, I
11 think, some comments and then I would like to turn it over
12 to the panelists, just around, you know, what has really
13 spurred the growth of portfolio trading in the last couple
14 of years, both from a markets and technology perspective. I
15 do think it's both of those things, right? I think on the
16 markets perspective -- from the markets perspective, you
17 know, the rise of passive investing, ETFs, underpinned by,
18 you know, periods of low rates and low volatility have, you
19 know, really been the macro backdrop for the general
20 interest and desire to trade baskets of securities and think
21 about those baskets of securities again as one package with
22 one price, you know, by their features and by their factors,
23 as opposed to only thinking about them on a fundamental
24 basis per bond.
25 Likewise, I think advances in data and technology

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1 in the last several years, certainly since the crisis, have
2 been sort of a natural catalyst for this conversation to be
3 possible for the marketplace to be working on these types of
4 initiatives.
5 But, Josh, I would love your perspective on
6 portfolio trading, how it is evolving and also, please, how
7 it is different from what we would think of in the past of
8 the more traditional bid wanted, offer wanted and comp
9 lists?
10 MR. BARRICKMAN: Sure. It's definitely evolving
11 quickly. And I think you touched on the main reasons for
12 it. To me, one of the biggest catalysts is really the
13 quality of prices that are available in the marketplace. I
14 think Lynn mentioned earlier the service that ICE has and,
15 you know, portfolio trading is -- it really, you know, gets
16 velocity when you have a trusted point to anchor to in the
17 market. So if you have prices that you know are very good,
18 you're very comfortable then thinking about your portfolio
19 trade as a spread off of those or as a total market value
20 relative to the, you know, what would come out with the
21 various prices that you select.
22 In terms of the difference between a portfolio
23 trade and your regular offer wanted and comp or bid wanted
24 and comp, number one is just volume. So number of line
25 items tends to be much larger in a portfolio trade. Your

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1 traditional trading tends to be maybe bigger lots but
2 smaller number, you know, go out in comp to a number of
3 dealers. You're really trying to get a very large,
4 diversified basket in a portfolio trade. So I would say
5 it's a little bit more beta driven. So again, in line with
6 kind of the passive -- the surge in passive that we've seen,
7 where with BWIC, I'd call it a bit more tactical or
8 surgical, where you're going after, you know, a certain few
9 names to either express a view or to plug some holes in your
10 portfolio.
11 You know, so like you said, it really lends itself
12 very well to the passive market and, in particular, the ETF
13 ecosystem as I think the market has gotten much more
14 comfortable trading baskets of bonds to create and redeem
15 ETF shares. It aligns itself perfectly with portfolio
16 trading.
17 MS. THEISEN: Great. So would you describe those
18 as kind of the main drivers of portfolio trading? So, you
19 know, portfolio creation, optimization, sourcing ETF risk,
20 index rebalancing, redemptions, are those kind of the key
21 drivers that you would see?
22 MR. BARRICKMAN: Yeah, they are. I would say the
23 big use cases are around inflows into a portfolio, or that
24 end-of-the-month rebalance of an index.
25 MS. THEISEN: Great. Thank you very much.

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1 Lynn, could you maybe walk us through the actual
2 mechanics of a typical portfolio trade as you see them
3 happening, including pricing and execution? And, of course,
4 what is the role of data and pricing services and composites
5 in this ecosystem?
6 MS. MARTIN: Actually, Sonali, you actually raised
7 a great parallel with how these things started, which is
8 really the liquidity that is in the ETF marketplace. And
9 you can't ignore the fact that there has been such
10 significant growth in fixed income. ETFs is a very liquid
11 way to get exposure. So as Josh was saying, it makes
12 perfect sense that you would want to extend the concept of
13 transacting a basket to not just ETFs in the creation-
14 redemption mechanism, but also to get liquidity in the fixed
15 income markets.
16 So effectively it's, the way the trade works is
17 effectively, you will have an asset manager or dealer, or
18 two market participants agree a basket of multiple
19 securities. They could be a small amount of securities,
20 large amount of securities, 30 or more. And it will have a
21 variety of components, where you have a mixture of buys and
22 sells. You could have some liquid, some illiquid bonds in
23 the basket. And once the trade is agreed, it will be
24 reported to TRACE within 15 minutes of -- of execution of
25 the portfolio itself, either by the dealer or if it was

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1 executed through an ATS, by the ATS, as Josh was indicating.
2 It makes perfect sense from a cost efficiency
3 standpoint and a market efficiency standpoint that these
4 trades have continued to increase in popularity. Typically,
5 the cost of the portfolio will be better or equal to what an
6 asset manager or market participant by individually trying
7 to source and synthetically create these, this basket. So
8 from our perspective, that's a good thing. Anything that
9 adds transparency and liquidity to the fixed income
10 ecosystem is a good thing.
11 What makes it a little bit challenging from a data
12 vendor perspective is we see these prints go through, but we
13 don't know that they were as part of a portfolio. So in the
14 basket itself, you may see one component where the print
15 looks a little bit off relative to a previous print. Or in
16 a very illiquid bond, you just may wonder why that print
17 occurred at that price. Right now, there is no way to
18 ascertain whether or not it was part of a portfolio or it
19 was part of a naked transaction, someone trying to manage
20 their inventory, whatever the case may be.
21 So, from our perspective, the recommendation will
22 eliminate a lot of that noise and will just help us
23 understand the mechanism as to why and how the trade was
24 executed. Which, in our view, will impact, you know,
25 various analytics, as I mentioned before, liquidity as well

1 as some of our pricing services.
2 MS. THEISEN: Thank you. And, of course, from the
3 data, the usage of a pricing service in the portfolio
4 transaction, would you, you know, argue that that's
5 obviously been something that's been growing?
6 MS. MARTIN: Absolutely. Index providers, in
7 particular, as well as folks whose data is used to strike
8 NAV, which we have popular services in both areas, as
9 passive investing continues to grow, as firms look to
10 decrease slippage throughout the course of the day, clearly,
11 clearly the use of independent data as a way to benchmark
12 these portfolios against it is growing in popularity.
13 MS. THEISEN: Great, thank you.
14 Ola, I would like to turn to you for a moment. If
15 you could give us your thoughts from, again, FINRA's
16 perspective? I know you have looked at some data around
17 what we have described as a portfolio transaction. What is
18 your expectation in terms of, you know, if we were to move
19 forward with this type of a recommendation, what we would
20 see in the data?
21 MR. PERSSON: Yeah, so the recommendation has four
22 criteria for what constitutes a portfolio trade and it's
23 only two of those we that we can actually observe in the
24 data. We can see -- items and we can see if it was against
25 one counterparty. Having said that, if there's a customer



1 on the other side, we're making some assumptions there.
2 We cannot determine in the data if it was an all
3 or none or if it was priced as a portfolio. But we can see
4 -- same dealer, identical trade execution times, et cetera.
5 So we're making some inferences.
6 So whatever number I give you is a little bit of
7 guesswork here. So the reality may be slightly different in
8 this, but to give a sense of proportion in applying these
9 criteria back to show the growth in this.
10 So if you look at 2019, we think we saw around
11 2,200 trades that would constitute a portfolio trade, with
12 over 30 line items. In 2018, that same number, whether
13 that's exactly right or wrong, but proportionally would be
14 the same, in 2018 we saw around 1,150. So it's almost a
15 doubling from 2018 to 2019.
16 If you break that down, the 2,200, if you break
17 them down a little bit further, about 960 or close to 1,000
18 are customer transactions, with customers. About 500 --
19 actually, sorry, before I move off, that's actually up from
20 380 in 2018. So a significant growth in the customer
21 business.
22 There are around 500 of these between two dealers.
23 That's up a little bit from 2018 when it was 450.
24 The other area, though, where we've seen a lot of
25 growth are trades with affiliated entities, where a FINRA



1 member trades with an affiliated entity and it meets the
2 criteria that we can observe in the data. We saw around 725
3 in last year compared to 320 in 2018. So all of those
4 contribute to the overall growth.
5 I think the other thing, if we break it down by
6 quarter, it's a very steady increase over the last couple of
7 years. And in Q4 2019, we saw almost four times as many
8 portfolio trades by this definition as we did in Q1 2018.
9 And it's kind of a steady growth throughout the last couple
10 of years, quarter over quarter.
11 Our estimate -- guesstimate, I should say in this
12 case, based on what we see if this recommendation is
13 adopted, we think we see anywhere from 750, 850 trades a day
14 that would meet these criteria -- with the indicator. A
15 number of these involve a lot of line items. Actually,
16 almost 20 percent of customer trades have over 100 line
17 items, so that adds up quite a bit.
18 If you look at the volume -- that was number of
19 trades. If you look at the volume, we think this would land
20 somewhere in the realm 1 and one quarter percent of customer
21 volume would be subject to this flag. That's our estimate.
22 MS. THEISEN: Great, thank you. And I apologize,
23 I probably should have just given a very clear definition
24 again of what the recommendation is on portfolio trades from
25 the subcommittee sooner.



1 After much debate -- and, Horace, please feel free
2 to chime in here -- but after much discussion around how we
3 should define a portfolio, the subcommittee recommends that
4 a portfolio trade would be one that is executed only between
5 two parties, involving a basket of instruments with at least
6 30 unique issuers on a single agreed-upon price for the
7 entire basket that was executed on an all or none or most or
8 none basis.
9 And I would also clarify that it is our
10 recommendation that these trades be flagged with a qualifier
11 but that, you know, individual, separate portfolio trades
12 shouldn't be given their own sort of unique identifier to be
13 able to piece together which bonds were part of which
14 portfolio. While that might be evident in the tape, we are
15 not recommending that each portfolio itself have its own ID.
16 And so I think, Ola, with the data that you've
17 shared, please correct me if I'm wrong, but I believe that
18 what is observable today within TRACE is most likely those
19 first two criteria. But it's probably difficult for you to
20 be able to ascertain whether the trades were done at a
21 single agreed-upon price or were executed on an all or none
22 or most or none basis. Would that be an accurate
23 assessment?
24 MR. PERSSON: Yeah, that's correct. We can
25 observe the first two proposed criterias, we can't observe

1 the second two. That's correct.
2 MS. THEISEN: Great, thank you. And Lynn, maybe I
3 can come back to you. From a data perspective, again, how
4 would this recommendation benefit the market? And also, how
5 does this fit together with some of the other data
6 initiatives as well as, you know, recommendations that we've
7 put forth through FIMSAC?
8 MS. MARTIN: Yeah, I mean, I think it again
9 increases the transparency component and helps data vendors
10 understand why some of the individual line items are being
11 priced at the manner that they are. It also, I would say,
12 impacts, you know, liquidity, things of that nature, which
13 just allows firms to more accurately have their own TCA
14 tools and things of that nature.
15 MS. THEISEN: Great. And Josh, to what extent
16 would this information, if disseminated from a markets
17 perspective, do you think be useful to market participants?
18 So do you -- would you anticipate a modification of behavior
19 in terms of analysis or trading trends? And what if any
20 sensitivities, again, or objections or concerns do you think
21 we need to consider when thinking about this recommendation?
22 MR. BARRICKMAN: In terms of behavior change,
23 again, it's more transparency. I think when we think about
24 TCA, it makes it that much more robust if we can identify
25 trades that might look a little bit out of line and, you



1 know, haircut those or throw those out of the analysis.
2 Yeah, again, I think it's additional transparency,
3 so I really don't see a downside. It's not a -- not a
4 burden on us and it would just provide that much more
5 information.
6 MR. CARTER: The important thing to consider when
7 we're talking about what these trades look like is context.
8 And so when the trades get reported, right now, they're not
9 put in the context of a much larger trade. So if you're a
10 market participant, a trader or even a computer that's
11 following a single credit, then you would want to -- you
12 would want to decrease the emphasis of a trade that you knew
13 was part of a much larger trade on that specific issuer.
14 And so that's where -- that's the value and that's where you
15 get the enhanced transparency.
16 The sensitivity, I think, comes from transparency,
17 once again. And it's transparency in the -- depending on
18 what the composition of the portfolio is and the visibility
19 that market participants have into what the holdings of
20 investment managers are. It would be at least theoretically
21 possible to figure out who was executing these trades. And
22 conversely, also on the sell side. When market participants
23 execute large transactions, they don't necessarily want to
24 broadcast that to the entire market at the time. Because if
25 I just take on a large amount of risk, then it would be



1 possible for people that know that to front run me. And so
2 that's -- that's part of the sensitivity to it, I think.
3 MS. THEISEN: Josh, maybe we will come back to you
4 on that point. But do you think though in practice that
5 that information by market practitioners, and maybe Lynn as
6 well, is already being recognized in the data?
7 MR. BARRICKMAN: I think it's probably recognized
8 to some extent. Just in terms of the sensitivity, the
9 nature of these trades just are probably the least sensitive
10 trades that we really have going on, honestly, because
11 they're very broad, they're very diversified and they tend
12 to be very small.
13 So you might get, you know, a $10 million trade
14 with 100,000 line item average. Okay, somebody could kind
15 of piece that together. But I'm not really concerned.
16 Versus the more, you know, negotiated trades where you do 10
17 million in one name and you're maybe putting a position on
18 and that's something that you really want to keep pretty
19 close.
20 So I think just the nature of those trades -- I
21 mean, we're early innings and maybe this takes on a life of
22 its own and we start to do much, much bigger size and the
23 answer might change. But I think as it's constructed at
24 least for us in the passive side right now, it's a pretty,
25 pretty benign trade that I'm not, you know, terribly



1 concerned if it's, you know, understood by other market
2 participants.
3 MS. THEISEN: Great, thank you.
4 I also just want to mention one of the criteria
5 that the subcommittee considered and did not include in the
6 recommendation was a minimum notional size. So we did
7 debate this quite a bit whether, you know, under a certain
8 size, whether effectively there should be a floor. And our
9 view was that if the other criteria were being met that
10 there was really no purpose in sort of debating what the
11 size of a portfolio trade should be. Also in recognition
12 that market dynamics may change, and that size can, you
13 know, get bigger, get smaller over time. So we did feel it
14 was -- while we had some thoughts on what that number could
15 be or should be, we didn't necessarily think it was
16 worthwhile to include another criteria for measurement in
17 this instance.
18 And lastly, before we just move on to e-trading
19 very quickly, Ola, similar to the question around delayed
20 spot trades, what do you think from an implementational lift
21 perspective? Is this fairly similar, quickly?
22 MR. PERSSON: It's similar and on some level
23 easier, because this would be a modifier, add a value to an
24 existing modifier field. So there is very low complexity on
25 that and impact as well. It does trigger all the same

1 things I went through before. We have to update our feed,
2 our trade reporting interfaces, we have to update downstream
3 systems, compliance tools, the -- and similar impact, member
4 firms have to be able to report this information to us and
5 data consumers have to be able to consume it.
6 But again, it's an additional value in an existing
7 modifier field. We're not changing the message format or
8 anything, so very low complexity.
9 MS. THEISEN: Great, thank you very much.
10 I would like to just very quickly touch on one
11 point that, as you will see in the recommendation, we
12 discussed electronic trades, but we did stop short of a
13 formal recommendation of tagging them. Horace, if you don't
14 mind, could you just walk us through our thought process
15 within the subcommittee of not making a formal
16 recommendation?
17 MR. CARTER: Well, the ultimate reason was the
18 different regulations around the various trading platforms
19 right now and what qualifies as an ATS, what would qualify
20 as something that needed to be tagged as an electronic
21 trade. Because right now, you have various systems that
22 some are regulated under Reg ATS, some are regulated as
23 broker-dealers, some aren't regulated at all. So we
24 couldn't really come up with what the definitive
25 characteristic, what the definitive protocol would be to



1 warrant such a tag. And so that's the reason.
2 MS. THEISEN: Yeah, I would highlight that. You
3 know, FIMSAC in our July 2018 recommendation to review the
4 framework for oversight of electronic trading platforms had
5 noted within that recommendation the varying regulatory
6 treatment of e-trading platforms, some of which are
7 currently treated as ATS, some as broker-dealers and some
8 not currently regulated. I would also note that
9 specifically Reg ATS tends to exclude platforms with an RFQ
10 protocol, which is where, you know, electronic trading
11 happens.
12 So I think that both that issue, coupled with, you
13 know, the lack of current definition of what actually
14 constitutes an electronic trade versus voice processing and
15 all of the various protocols that exist. And then, lastly,
16 the varying levels of existing disclosure amongst what we
17 consider our trading venues prevented us from making a
18 formal recommendation in this area. But we do think that it
19 is of great public interest to be able to more accurately
20 understand the trends in electronic trading. And we have,
21 you know, I think very recently, heard questions around this
22 point particularly and whether, you know, those trades in
23 certain instances are getting not counted or recounted, et
24 cetera.
25 Just very quickly, in parting notes, if anyone has



1 any around electronic trading and how it's currently
2 measured? Lynn, maybe I'll start with you.
3 MS. MARTIN: Yeah, I mean, that's the challenge,
4 is what is an electronic trading venue, what is not an
5 electronic trading venue. And that comes back to the
6 recommendation that we did put forth in July. So I do agree
7 with the approach that the subcommittee is taking, in that
8 it's important to get that definition down or get that
9 consistent regulatory framework in place. Because I think
10 those of us with ATSs do see an increase in the amount of
11 activity going through and I think that's a good thing. I
12 think that's a good stat for the market and the evolution of
13 this asset class in general. But I think it's important to
14 have a common regulatory framework in place.
15 MS. THEISEN: Great, thank you.
16 Josh, any last thoughts on e-trading and how it's
17 been kind of evolving in the marketplace and whether you
18 think it's something we should be measuring?
19 MR. BARRICKMAN: It's evolving quickly. You know,
20 I think, as we said, the advent of really strong data
21 offerings in the pricing space have really fueled things
22 like auto-ex and a lot of new protocols in that space. I
23 mean, we're personally measuring it internally, to see how
24 much of our share is going to sort of all these different
25 protocols, including sort of traditional. So it's certainly



1 an area to continue to focus on.
2 MS. THEISEN: Thank you, Michael. And with that,
3 I'll turn it over to you for questions.
4 MR. HEANEY: Thank you. Let's open it now to the
5 FIMSAC committee members for questions or comments on the
6 preliminary recommendation.
7 Let me start first with anyone on the phone who
8 may have a question or a comment?
9 (No response.)
10 MR. HEANEY: Okay, I'll turn to Tom.
11 MR. GIRA: Yeah, just to echo something that
12 Horace said, I think any time we can add contextual
13 information about trades, particularly trades that might be
14 away from the current prevailing market, that's always a
15 good thing for the audit trail. So but I did just want to
16 sort of comment on a couple aspects of the proposal. And it
17 might be a little bit of a Debbie downer here.
18 Where I think we struck a good balance in terms of
19 the operational concerns to implement these filings or
20 proposals. But I would like to highlight though that I
21 think there are still going to be some recordkeeping
22 requirements that we'd want to make sure firms are aware of.
23 So specifically, with the spread trades, I think we'd want
24 to know -- not have it reported to us but a way to follow
25 up, to sort of validate that there's legitimate use of these

1 modifiers, what the benchmark was and what the spread was.
2 And similarly, on the portfolio trades, I think
3 we'd want to know what constituted the portfolio. And also
4 how was the overall price allocated to the components of the
5 portfolio? Because I would say we want to make sure that
6 there's a reasonable effort to try to allocate it
7 proportionally and consistent with the components of the
8 basket.
9 Because I think, worst case scenario, and I'm sure
10 none of the firms here would do this, but you could sort of
11 just throw up a portfolio modifier and if it is sort of a
12 reason to be away from the market, we want to make sure
13 that's linked to a portfolio and not a way to sort of go
14 under the radar if we're looking at best execution or
15 things, in terms of if there is something unique or
16 different about that trade. So I would just sort of
17 highlight that, that I think would be part of the ultimate
18 proposal.
19 MR. CARTER: So what I might recommend for FINRA
20 in that regard is to make that a part of FINRA exams,
21 instead of making it a part of the -- instead of making it a
22 part of the requirement. Because once -- as soon as you
23 start adding things like that, then you start to worry about
24 the cost/benefit, the cost/benefit equation there. So, you
25 know, FINRA is excellent at performing exams. And so



1 examining the portfolio trades for their validity might be
2 an option to avoid implementation of that particular --
3 MR. GIRA: Just to be clear, I was suggesting
4 exams. I wasn't suggesting that it would be enhanced
5 reporting. It would be sort of after the fact validation.
6 MR. HEANEY: Thank you, Tom. Gilbert?
7 MR. GARCIA: Very quickly, if there is a portfolio
8 transaction that had mortgage pools in it, is there going to
9 be any sort of changes or any thought to change or enhance
10 the TRACE data for mortgage pools, individual CUSIPs?
11 Because that's still something that's kind of clunky.
12 MR. PERSSON: So I think the context we are
13 talking about today is corporates, specifically.
14 MR. GARCIA: Understood. I just didn't know if
15 you all had considered that at all. What if that's part of
16 the portfolio transaction?
17 MR. PERSSON: In this context, we are staying
18 within the recommendation here.
19 I think, generally speaking, there is always some
20 benefit to consistency across trace products, for us but
21 also for member firms who code to the interfaces, et cetera.
22 But for the purpose of this discussion, I think we are
23 staying on corporates and I think we would have to look at
24 the practices in the mortgage market separately.
25 MS. THEISEN: And Gilbert, I think to add to that,



1 I think that, again, the protocol of trading portfolios is
2 evolving, and I think it very well may start to include
3 other asset classes and other bonds.
4 But I think today, what we see in practice in the
5 marketplace as we defined a portfolio transaction is really
6 happening in corporate bonds.
7 MR. HEANEY: Kumar.
8 MR. VERKATARAMAN: I think this is an excellent
9 proposal and I want to thank the subcommittee for working on
10 it.
11 My question relates to when this trade, which is a
12 late-day trade, is reported into the TRACE data. The
13 patterns that I see in the futures market, where you have
14 traded settlement contracts, so you've traded settlement
15 where the transaction takes place at 10:00 a.m. but the
16 benchmark price is the settlement price for the day and
17 there's a markup related to that. And if I understand
18 correctly, those last trades are reported at the time of the
19 trade and so it contributes to the price discovery
20 immediately.
21 So in that context, as I see a pattern with
22 respect to the corporate bond transactions, it seems to me
23 that one idea perhaps would be to report the trade at 10:00
24 a.m. when it happens but it's flagged as a trade that will
25 be settled at 3:00 p.m. So the 3:00 p.m. therefore takes



1 care of the settlement process where you are taking the 3:00
2 p.m. treasury and then the markup. But the transaction
3 itself gets reported at 10:00 a.m., contributes to price
4 discovery. So I was wondering whether the committee had
5 thought about that.
6 MR. CARTER: So we did consider that in depth.
7 And we decided that operationally, it was just too heavy a
8 lift to try to implement it. Because it would require what
9 is, in effect, the submission of a slate into your order
10 management system that would report and then the price would
11 populate at the spot time.
12 And so, an order of magnitude greater operational
13 lift was, I believe, the term that was used for that. So we
14 did consider it and we just didn't think it was worth it.
15 MR. HEANEY: I just want to make sure I heard then
16 correctly. But this preliminary recommendation was kind of
17 step one. And what you were offering up to, if should it go
18 through to FINRA or the Commission, is to think about that
19 as step two; is that right?
20 MS. THEISEN: Yes. I think that, you know, we do
21 think there would be value. And again, if the trade
22 happened at 9:30 at 165 over treasuries, that that 165 over
23 treasuries would be reported at 9:30. And then later in the
24 day, that the actual price, et cetera, will be reported.
25 But again, for the sake of making sure as well, Michael,

1 that we didn't just then do that just for delayed spots, but
2 for all investment grade bonds, like that would be a much
3 bigger change to the TRACE framework, in our discussions
4 with FINRA. So we thought that that would be something that
5 FINRA and the Commission could consider as a phase two.
6 MR. HEANEY: Elisse.
7 MS. WALTER: My question is about both the last of
8 what you talked about and whether you also talked about
9 recommending that the Commission take another look at the
10 line between ATSs and exchanges. The exchanges have
11 complained for a long time that there is an imbalance in the
12 responsibilities imposed on them and the responsibilities
13 imposed on ATSs. And without taking a position on that, now
14 that ATSs have become very well established, have you
15 thought about whether it's time to take another look at that
16 and see if that line needs to move?
17 MR. McVEY: I'm happy to take that one. As a
18 practical matter, almost all the trading electronically in
19 the U.S. fixed income market today is either on an ATS or an
20 RFQ system that's regulated as a broker-dealer. So that
21 line is far more relevant than the ATS versus the exchange.
22 And that was the subject of our first --
23 MS. WALTER: Do you really think so? Because, I
24 mean, that's relevant because that's where it is. But on
25 the other hand, if in fact those ATSs -- and I don't know



1 the answer. But the ATS really has evolved to the point
2 where, in effect, other than the product class, there really
3 isn't any difference between the functions being performed.
4 The question is whether the regulatory framework is
5 establishing an artificial barrier to competition or an
6 artificial advantage to one over the other.
7 MR. McVEY: I don't think we would exclude it from
8 our first recommendation, which is to have a common
9 regulatory framework for all electronic trading in fixed
10 income, which could incorporate exchanges as well.
11 MR. HEANEY: Larry.
12 MR. HARRIS: I strongly support these proposals.
13 That said, I want to speak to some things that I think
14 should be done further.
15 First of all, I want to second Kumar's comments
16 about the importance of reporting trades as they occur. So
17 the whole purpose of TRACE was to allow us to know what's
18 happening in the markets. And TRACE was originally set up
19 with the understanding that all trades were denominated in
20 purchase price dollars.
21 It turns out that a number of trades are
22 denominated in terms of spread, essentially a different
23 currency. But they are still trades and there's no question
24 that the trades are being negotiated at, you know, 10:00,
25 11:00 or 12:00 and not at 3:00 or 4:00 when they're getting



1 reported.
2 So in effect, we have delayed reporting for these
3 larger trades. And that's just contrary to the basic
4 principle of TRACE. So I recognize that it's a heavier lift
5 to do the proper reporting. But the whole purpose of TRACE
6 is to get that information out. And so I would argue that
7 the lift is worthwhile.
8 With respect to portfolio trading, the
9 distinguishing characteristic of a portfolio trade, and the
10 reason that we're concerned about this, is that there is a
11 single price for the portfolio. And underlying that single
12 price, there is some sort of matrix pricing for the
13 individual trades. So the present proposal says that we
14 should implement these new procedures for portfolio trades
15 whenever there are 30 or more transactions or lines, as they
16 have been called, associated with the portfolio. But the
17 truth was that the principle applies to any transaction
18 where there are more than one line, more than one line, with
19 prices being somewhat arbitrarily assigned.
20 And so I think that the 30 ought to be brought
21 down to two. I don't see any additional cost because
22 anybody who is using a system that is working it this way,
23 it goes into that system. And, in fact, if anything, that
24 would actually lower the cost because then you wouldn't have
25 to have two different systems, one for -- or essentially



1 three different systems, one for single trades, one for
2 trades between two and 29 and another for above 30.
3 MR. HEANEY: So can I give the opportunity for
4 either Rick or Sonali to address that? Because that came up
5 obviously extensively on the subcommittee, within the
6 subcommittee.
7 MS. THEISEN: Sure, I'd be happy to jump in.
8 So, Larry, your point is well taken. I think
9 again, what we were attempting to capture with the
10 definition of a portfolio trade is the changing market
11 structure that is a relatively recent phenomenon of moving
12 away from pricing individual line items to giving a price on
13 a factor or feature basis for an entire portfolio.
14 And I can say from the perspective of a dealer in
15 the space, you know, when we trade two or three line items,
16 we are thinking about the risk in each of those two or three
17 line items, we are not thinking about that as a diversified
18 basket, where we would be pricing the entire basket for one
19 price.
20 So we wanted to make sure that the definition of a
21 portfolio trade accurately captures in the marketplace what
22 people are observing as a trend and a change. Which is,
23 again, towards trading large baskets, diversified baskets at
24 one point for a block risk transfer or a large risk transfer
25 or diversified risk transfer if not large. And so if we

1 started to capture trades of two or three or 10, we think it
2 would be misleading to the marketplace to signal those as
3 portfolios because it doesn't accurately describe what we're
4 seeing reported and discussed in the marketplaces today.
5 MR. CARTER: May I respond? It would also make it
6 harder for FINRA to do an effective review of that. It
7 would be easier to take advantage of that flag if you were
8 able to say, well, this is a portfolio trade of two trades.
9 That would make it more difficult for their review.
10 MR. McVEY: Just one other point I would add. A
11 far greater percentage of TRACE every day is conducted
12 through bid and offer lists that are highly competitive and
13 are negotiated line item by line item. So the committee
14 really did not want to confuse the pricing mechanism that is
15 now taking place for 1 or 2 percent of the market through
16 portfolio trades with what goes on all day long with
17 competitive bid and offer lists where every line item is
18 negotiated separately. And we would view those prints on
19 the TRACE tape as highly confident, highly credible prints.
20 MR. HARRIS: So Rick's point, all these points are
21 well taken. I would suggest with respect to this and also
22 with respect to the electronic trading reporting issue that
23 we adopt a principle-based approach as, opposed to a rules-
24 based approach to reporting.
25 So the principle is, if you negotiated the trade



1 line by line, then it's a line-by-line trade. But if you
2 negotiate it as a package, it's a package trade and doesn't
3 matter whether there are two or 20 or 50 or 100. And that
4 principle is fairly easy to establish and it's certainly
5 easy to audit.
6 Same thing with electronic trading. We are
7 wrestling with an attempt to figure out what an electronic
8 trade is. We all know what an electronic trade is. It's a
9 trade that's done by a computer, where there wasn't a human
10 intervention. And so that's just a simple principle. And I
11 don't know why we have to define the actual source for each
12 one of these trades. If the trade is done through a dealer
13 in electronic systems and there was no negotiation on
14 prices, it's an electronic trade. It's very simple. So I
15 would suggest that we think more about principle versus
16 rule-based requirements, both for electronic trading but
17 also for the portfolio trading.
18 The last thing I wanted to say was to echo a
19 little bit of what Tom said, is that we do have to be
20 careful about regulatory issues. In particular, for the
21 portfolio trades, I think if we're not going to report a
22 common identifier for the portfolio trade, we have to make
23 sure that people are reporting all these trades
24 simultaneously. So that is going to reveal it anyway. But
25 if there is any gaming as to, you know, some trades get



1 reported later than others, deliberately so, that's
2 problematic.
3 And then also to the extent that prices are being
4 assigned, we're putting a flag on that says that the prices
5 coming out of a portfolio trade, that's fine. But let's
6 make sure that one of those prices isn't substantially
7 different from the other because somebody wanted to report
8 it differently. So there might be some recordkeeping
9 requirement that says that this was based on third party
10 pricing or something like that, so somebody can't just stuff
11 one trade in with a crummy price for some purpose that is
12 antithetical to the health of our markets.
13 MR. HEANEY: Ananth.
14 Thank you, Larry.
15 MR. MADHAVAN: First of all, I'll thank the
16 subcommittee for these recommendations that I think are very
17 sensible. To Larry's point, I do think it's worth noting
18 that, obviously, in the current setup with TRACE, we have
19 time stamps that are reported. So in the proposal it was
20 noted, and I think correctly so, that one can actually infer
21 a portfolio trade because all of the transactions have the
22 same exact time stamp. So I just wanted to make that point,
23 it's there in the document. But it's worth considering in
24 the light of this discussion.
25 MR. HEANEY: I'm sorry. Amy.



1 MS. EDWARDS: Thank you. This is a very
2 interesting panel and recommendation. I just wanted to
3 learn a little bit more about the allocation of prices in
4 TRACE as they exist right now. So my understanding is that
5 this is a portfolio trade, you negotiate one price. And
6 when it's reported to TRACE, the prices of the individual
7 bonds are not necessarily close to the market. Obviously,
8 they've been allocated somehow.
9 So I just wanted to get a sense of what the
10 practice is in allocating these prices, and how often they
11 are different from the market price. Is it that only a few
12 of the individual names are off from the market price, or do
13 they all tend to be off from the market price?
14 MS. THEISEN: I'm happy to start and Josh or Lynn
15 or anyone, please chime in.
16 So I don't think there is any intention to trade
17 away from the market. And again, I can speak from Bank of
18 America's perspective. We will typically price a portfolio
19 based on a pricing service that is selected by the investor
20 and use that as sort of the framework for pricing, and then
21 price the entire portfolio on a proceeds basis. So you're
22 really using that -- again, that third party composite
23 that's been selected as sort of where you're sort of marking
24 the bonds. And you're adding some sort of spread to each
25 one of those bonds in a fairly consistent format.

1 While there could be a discussion around bonds, I
2 think why we don't think there is a gross mismarking of
3 bonds, we think where the edge cases may be is if a bond is
4 simply, you know, illiquid and the composite provider
5 doesn't have what may reflect the most -- you know, if
6 someone was to actually quote that bond today, the most
7 recent quote from a dealer. We just think that's impossible
8 to expect that, in a hundred percent of instances, given
9 where we are in the evolution of data composites, that the
10 pricing is always accurate.
11 But generally speaking, we are trading portfolios
12 using a third party composite price as the sort of the
13 benchmark.
14 MR. HEANEY: I would remind the group of just a
15 couple of things. First, I think the subcommittee -- I know
16 the subcommittee had strong support for this. And I think
17 acknowledged in this conversation, it's a starting point.
18 And I think, you know, additional enhancements can come
19 either through the comment period or down the road. So I'm
20 stating the obvious but just reminding everybody that
21 although it may be not the end game, it's a good starting
22 point and we'll start this process headed to the right
23 direction.
24 So with that, and with the fact that I have
25 thoroughly run over all day, and I believe we've heard



1 everyone who would like to speak on the topic, I am going to
2 entertain a motion for the vote on the recommendation.
3 MS. WALTER: So moved.
4 MR. HEANEY: Thank you. Thank you.
5 All those in favor of the recommendation, please
6 raise your hands.
7 All those opposed, please raise your hands.
8 (Show of hands.)
9 MR. HEANEY: All those abstaining, please raise
10 your hands.
11 And on the phone, please. I'll start with
12 Suzanne.
13 (No response.)
14 MR. HEANEY: Matt, are you on the phone?
15 MR. ANDRESEN: Yes. I vote yes.
16 MR. HEANEY: Okay, thank you, Matt.
17 Lee.
18 MR. OLESKY: Yes.
19 MR. HEANEY: Thank you.
20 Just one more time. Suzanne?
21 (No response.)
22 MR. HEANEY: Okay. So for the benefit of those on
23 the phone, we have 17 that were in favor, no abstentions, no
24 one opposed.
25 Thank you very much. It's been approved by the



1 committee.
2 Thank you, Sonali, for moderating a great panel;
3 Rick, for your leadership on the subcommittee to get us to
4 this point.
5 I would like to thank all the panelists as well
6 for coming and sharing your thoughts, especially those who
7 have traveled here to do so.
8 With that, we will go to our lunch break and be
9 back here at 1:15 sharp, which will be 15 minutes later than
10 stated in the agenda. But 15 minutes later at 1:15 to start
11 the afternoon. Thank you all.
12 (Whereupon, at 12:45 p.m., a luncheon recess was
13 taken.)
14 A F T E R N O O N S E S S I O N
15 MR. HEANEY: Thank you, welcome back.
16 DRAFT MUNICIPAL SECURITIES TRANSPARENCY RECOMMENDATION
17 REGARDING TIMELINESS OF MUNICIPAL ISSUER DISCLOSURES
18 MR. HEANEY: We will turn to our first panel this
19 afternoon that will consider the preliminary recommendation
20 from the municipal securities transparency subcommittee on
21 the timeliness of municipal issue disclosures.
22 I will turn it over to Lynn Martin, chair of
23 municipal securities subcommittee and moderator of this
24 panel. Lynn.
25 MS. MARTIN: Thank you, Michael. Thank you



1 everyone for being with us today.
2 Before we get started, I do want to point out that
3 this is probably the most diverse panel or one of the most
4 diverse panels that we've ever had at FIMSAC. I think it's
5 absolutely amazing that we have a panel of all women,
6 considering --
7 (Applause.)
8 MS. MARTIN: I think it deserves a round of
9 applause too, considering such a thorny topic. And as you
10 will hear, these are subject matter experts. So I'm really
11 looking forward to today's discussion.
12 This topic has been covered in not just the muni
13 transparency subcommittee, but it also was covered by the
14 credit ratings subcommittee as well in a bit of a more
15 tangential fashion. And it's an issue that keeps coming up
16 in the market, really one focused on the timeliness of
17 financial disclosures in the muni market, both on an audited
18 financial statement basis but also on an interim disclosure
19 basis.
20 Just to set the stage a bit, and as we put in our
21 recommendation, the amount of time that elapses between
22 financial information being available for municipalities
23 tends to vary greatly in the market. So there's a lot of
24 reasons for that and a lot of that we are going to talk
25 about today. But effectively, what we are looking to do is

1 more set the stage as to where we have identified that there
2 could be improvements but not be overly prescriptive as to
3 what those improvements could be. Rather, we think that is
4 something that should follow after FIMSAC by more of a
5 subject matter experts to take on themselves.
6 So with that, and the one area that did become
7 very apparent during our discussions at the subcommittee
8 level as well as on the various panels that have preceded us
9 is just there is a misunderstanding of the way financial
10 disclosure information is currently regulated in the market.
11 So maybe Rebecca, could you give us an overview as
12 to what the disclosure framework looks like today, what the
13 practices are in the market, is there a regulatory framework
14 in place, et cetera?
15 MS. OLSEN: I would be happy to. I think that's
16 an excellent way to start the dialogue. And I will also
17 note there is some good detail in the recommendation, for
18 those of you who read that, the background section.
19 So the municipal securities market has not been
20 subject to the same level of regulation as other sectors of
21 the capital markets. Both our Securities Act of 1933 and
22 our Securities Exchange Act of 1934 were enacted with broad
23 exemptions for municipal securities from all of their
24 provisions except for the antifraud provisions. So what
25 does this mean exactly?



1 Well, let's consider a corporation, for example.
2 As a general matter, a corporation before they -- unless
3 they can rely on exemption, before they can offer the
4 securities to the market, they have to come in and register
5 their debt with the Commission and the SEC has a form that
6 requires specific line item disclosure, and that form is
7 subject to review by the SEC staff for completeness.
8 In addition, the Exchange Act requires
9 corporations to provide ongoing information to the
10 Commission, again on SEC forms, an annual report on Form 10-
11 K, quarterly reports on 10-Q, current events on 8-K. They
12 also require specific line item disclosure so long as their
13 debt securities are outstanding. So none of these
14 requirements apply to issuers of municipal securities.
15 So in the absence of a registration reporting
16 regime for municipal securities, the Commission's investor
17 protection efforts in this space have been done primarily
18 through, I would say, five different mechanisms. So first
19 would be enforcement of the antifraud provisions of the
20 federal securities laws against municipal issuers and other
21 municipal market participants. So broadly speaking, these
22 provisions prohibit deceit, misrepresentation and fraud in
23 the offer, purchase and sale of securities to the public.
24 They apply to all information by a municipal issuer to the
25 public that is reasonably expected to reach investors in the



1 trading markets. This includes primary offering documents
2 and continuing disclosure documents filed on EMMA and
3 includes other disclosures made publicly available as well.
4 And the Staff in my office happened to put out a Staff legal
5 bulletin on this topic last Friday which I think has been
6 circulated at least to the subcommittee. I'm not sure if
7 the full FIMSAC got it.
8 Second has been through registration and
9 regulation of broker-dealers and municipal securities
10 dealers. So in 1975, Congress amended the Exchange Act to
11 create a limited regulatory scheme for municipal securities
12 markets at the federal level in response to the growth of
13 the market and also perceived participation -- increase in
14 retail participation and perceived abuses.
15 So basically, these amendments require firms
16 transacting business in municipal securities to register
17 with the Commission as broker-dealers, and banks dealing in
18 muni securities to register as municipal securities dealers.
19 And we have Commission rulemaking authority over all broker-
20 dealers and municipal securities dealers.
21 The amendments also created the Municipal
22 Securities Rulemaking Board and gave it authority to
23 promulgate rules governing the sales of municipal securities
24 by broker-dealers and municipal securities dealers.
25 Notably, none of these amendments create a regulatory regime



1 for or impose any direct requirements on municipal issuers.
2 The amendments also included a provision called the Tower
3 Amendment, which limits the SEC and the MSRB's authority to
4 require municipal issuers to make any type of presale
5 filing.
6 So, for example, what we do on the corporate side
7 is specifically prohibit it. But however, I would note the
8 Tower Amendment does not preclude the Commission from
9 promulgating disclosure standards in municipal offerings.
10 But they did not give us any express statutory authority to
11 do so.
12 Third, I will mention Rule 15c2-12. So the
13 Commission exercised its authority over municipal security
14 brokers and dealers by adopting and subsequently amending a
15 rule called 15c2-12, which is the municipal securities
16 disclosure rule. And I will just say kind of basically it
17 does indirectly what we do on the corporate side in a way,
18 through the regulation of broker-dealers. So it obtains
19 primary market disclosure by saying an offering that's
20 subject to the rule can't go to the market until the broker-
21 dealer has received and had an opportunity to review an
22 official statement, a disclosure document. And then finally
23 it says that same underwriter can't sell the securities
24 until they've gotten a contractual commitment from the
25 issuer to provide continuing disclosure to the market. And

1 this consists of annual information, which may or may not
2 include audited information, as well as event notices.
3 So I think the very important point here is this
4 is -- while we make the broker-dealer ensure it's in place
5 before they sell the securities, it is just a private
6 contract. So it's a private contract from the issuers to
7 the trustee, typically, or for the benefit of the bond
8 holder. So it's not something that the Commission can
9 enforce.
10 Finally, I will also note Rule 15c2-12 did set up
11 the EMMA system as the central repository for the municipal
12 securities market. So all information goes there, primary
13 disclosure documents, continuing disclosure documents, as
14 well as trade reporting and other information of the like.
15 A couple other ways I'll just quickly mention
16 that we regulate the market is through the registration and
17 regulation of municipal advisers. And then another
18 important area is interpretative guidance, and this could
19 come from the Commission and the Staff. And the Commission
20 in the past has interpreted the antifraud laws to kind of,
21 you know, let market participants understand their
22 expectations for how to comply.
23 And with that, I'll turn it back over to you,
24 Lynn.
25 MS. MARTIN: Okay, thank you, Rebecca.



1 So just to get things started, I wanted to quickly
2 introduce our panel and then we'll get into the meat of the
3 recommendation as well as an overview of the market today.
4 So with us on the panel today is, representing us
5 from FIMSAC, the FIMSAC members that we have already, is
6 Giedre Ball, who is with the Metropolitan Washington
7 Airports Authority, and Elisse Walter former SEC Chairman.
8 And then we also have, representing the buy side, we've got
9 Akiko Mitsui from Vanguard and Hannah Sullivan from Fidelity
10 and Emily Brock from GFOA, who is going to provide an
11 important perspective on this as well.
12 Okay. Moving on to the topic at hand, so, Elisse,
13 there was a paper that you were directly involved with in
14 your time at the SEC back in 2012. Would you mind providing
15 a summary of what the conclusions were that were reached by
16 the Commission back in 2012?
17 MS. WALTER: Not at all. If you don't mind, Lynn,
18 I would like to take a minute first and, as a prelude to the
19 views I'll give later, explain my contact with this issue,
20 my involvement with this issue, which goes back to the mid-
21 '90s, when I was tasked with trying to figure out how to
22 describe the application of the antifraud provisions in the
23 municipal market. I was then with the Division of
24 Corporation Finance and Amy Starr and I worked very closely
25 with the Division, then, of Market Regulation to develop --



1 we developed the interpretive release that came out in '94
2 and the folks in Market Reg developed significant amendments
3 to 15c2-12, which have been built on several times since
4 then.
5 It was actually the last major project I worked on
6 before I left the Commission and was proud to have done it.
7 I called it turning a sow's ear into a silk purse. And I
8 thought, given what we had to work with, we did a pretty
9 good job of coming up with something that was extremely good
10 for investor protection and worked in the marketplace.
11 When I got back to the SEC in 2008 as a
12 commissioner, I immediately sort of zeroed in on this issue,
13 the timeliness issue and other issues relating to disclosure
14 in the municipal securities markets, because other than the
15 very welcome and seminal advent of EMMA, it struck me that
16 very little had changed in the 12 years since I had been
17 gone. And, in fact, I chose this as my topic when I was
18 asked to give the Al Sommer Memorial Lecture at Fordham,
19 which is supposed to focus on critical problems confronting
20 the financial markets. So if you want to get really bored
21 and have a much longer history of what's gone on in the muni
22 markets, I don't commend that speech to you, but it is out
23 there.
24 And a couple years after that, Mary Schapiro, my
25 friend, boss, mentor -- even though she's younger than I am,



1 damn her -- asked me to work with the Staff to do a study of
2 the municipal markets, which covered more market-related
3 issues. Today, we're here to discuss a disclosure-related
4 issue. And that led to what we originally thought actually
5 would be a Staff report.
6 We conducted three field hearings, although we
7 cheated a little bit because money was scarce and the third
8 one was in D.C., but we still tried to conduct it like a
9 field hearing. We had innumerable phone calls and meetings
10 with participants in the marketplace to get both information
11 about how the market was operating and their views on what
12 should be done.
13 And in 2012, we presented to the Commission a
14 recommendation to issue the Staff report. And as luck would
15 have it, or maybe it showed the depth of the Staff's efforts
16 -- really them, not me -- the Commission voted to turn it
17 into a Commission report. And that is the thing that is
18 always called the 2012 Report, with either love or
19 agitation. And it had a series of recommendations, which
20 was focused very much, consonant with what you said before,
21 Lynn, it was focused very much on not creating a revolution
22 but on building what was out there in the marketplace and
23 trying to make incremental recommendations to make things
24 better.
25 I'll take a minute and do what you actually asked

1 me to do, which is to talk about the recommendations that
2 actually dealt with the issue we are here to discuss today,
3 which is the timeliness of financial disclosure. And there
4 were a series of recommendations. First, legislative
5 recommendations. One suggestion was made that the
6 Commission could consider recommending, understanding that
7 the Commission can't enact legislation, unfortunately, but
8 consider recommending to Congress that there be legislation
9 to require official statement and disclosure throughout the
10 term of municipal bonds, including the authority --
11 important here -- to set time frames and minimum disclosure
12 requirements. And also provide the tools necessary to
13 enforce those requirements, so they wouldn't just be
14 enforceable through antifraud but through, for example, a
15 case or an administrative proceeding for failure to meet
16 disclosure requirements if there wasn't a fraud violation.
17 Also, legislation to set the form and content of
18 financial statements and to recognize a private sector body,
19 presumably GASB, to kind of mirror the FASB in the -- I
20 don't think the Commission was interesting in setting
21 municipal accounting standards itself. I know we weren't.
22 Third, to authorize the Commission to require that
23 there be audits. And that is an issue that extends out into
24 secondary market disclosure. Because, as most of the people
25 here know, if you don't have an audit to begin with, you



1 don't need an audit in the future. To provide, as is
2 recommended here, a safe harbor from private liability for
3 forward-looking statements, which has worked fairly well in
4 the corporate environment.
5 And importantly, and I think it's worth bearing
6 mention, because everyone always misunderstands this. They
7 did then, they do now. The Commission was not seeking to
8 require -- to repeal the Tower Amendment and was not seeking
9 the authority and we didn't recommend it for municipal
10 issuers to be required to file with the Commission and/or go
11 through a review process with the Commission.
12 On the regulatory basis, we recommended updated
13 interpretative guidance. And I would like to thank Rebecca
14 for taking that off of the table at least for the next few
15 years. And I thought it was very effective and a lot more
16 concise than what we put out in 1994. So once again, I
17 would like to publicly congratulate her for that document
18 that just came out.
19 And for the Commission to take another look at
20 Rule 15c2-12 and see how many other ornaments could be hung
21 on that tree. We were very uncomfortable with that because
22 we did feel that, over the years, the Commission,
23 particularly since '94, had pushed 15c2-12 pretty hard.
24 Understandably, because it really was the only tool that it
25 had that would work.



1 So many of those recommendations have been
2 undertaken and completed. But the issue that we are here to
3 discuss today, the timeliness issue -- also the content
4 issue but we're really here to discuss the timeliness issue
5 -- remains open. And although, at least in my view, there
6 has been some progress made on that, there hasn't been a
7 great deal of progress made on that in the last, you know, I
8 guess it's more than 25 years.
9 MS. MARTIN: Great. Emily, can you give us your
10 perspective on what has changed since 2012?
11 MS. BROCK: Sure. I think that we've had an
12 opportunity in the market to witness an industry coming
13 together to address specific challenges. There has been
14 significant outreach by the Municipal Securities Rulemaking
15 Board to the industry to enhance EMMA as a useful tool to
16 input data and to be a resource where investors could
17 extract data from. The other thing that industry has come
18 together on is pension disclosure and making sure that it
19 was extremely transparent to our issuers.
20 We have seen a lot more issuers utilize the EMMA
21 platform in the form of creating issuer homepages. We have
22 also seen issuers kind of seek web-based solutions to create
23 investor relations websites. And GFOA, we are probably best
24 well known for our best practices. GFOA, as an
25 organization, we have 21,000 members. We host webinars



1 where we have about 6,000 issuers on any given webinar. We
2 have an annual conference that gets 10,000 issuers into the
3 same place. So these best practices are not taken lightly.
4 They are very specific. They are very instructive. They
5 describe a process where issuers may be able to utilize
6 effective tools that will help them communicate very
7 important elements to the investors. As we continue to note
8 in our best practices, we acknowledge that access to
9 information helps to improve efficiencies in the market, and
10 we continue to provide those documents, especially since
11 2012.
12 MS. MARTIN: Akiko and Hannah, what has your
13 perspective been, both from the market dynamics standpoint,
14 as well as what you've observed from a disclosure
15 standpoint.
16 MS. SULLIVAN: Sure, I'll start. There has been
17 marginal improvement since 2012, in large part because when
18 the 2012 report came out, I think the municipal market as a
19 whole took it very seriously, saw the writing on the wall
20 that this was an area that the SEC was very focused on and
21 that the market should be focused on. That came hand in
22 hand with a number of really critical SEC enforcement
23 actions. I think that really assisted in getting the issuer
24 and underwriter community to focus their attention on these
25 issues. And then there was the SEC program, MCDC, the

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1 Municipal Continuing Disclosure Cooperation Initiative,
2 which allowed underwriters and issuers to self-report
3 disclosure issues in their official statements. That was a
4 program that resulted in 72 underwriters. So by the SEC's
5 estimate, that was 96 percent of the market share for
6 underwritings coming to the table, and 71 issuers were found
7 to have used offering documents that contained materially
8 false statements or omissions about compliance with
9 continuing disclosure obligations. And the SEC did take
10 note of the diversity in the types and the size of issuers.
11 So those efforts were meaningful in really getting
12 underwriters and issuers focused on these issues and even
13 created a little bit of tension between those two parties.
14 Which, from the investor standpoint, really assisted that
15 focus in beefing up disclosure, including continuing
16 disclosure.
17 I agree with Emily, the developments of EMMA and
18 certainly issuer websites has been helpful. The 2018
19 amendments to 15c2-12 were a big step forward. Probably
20 didn't go as far as we would have liked them to go but
21 certainly a step in the right direction.
22 I will also say I think it has to be said that,
23 from my perspective, there has also been a step backward,
24 despite the several steps forward. And that was in 2017,
25 the MSRB Market Advisory on Selective Disclosure. I believe

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1 that that was a well-intentioned advisory, but the results
2 of that disclosure guidance really had a chilling effect on
3 some of our interactions from the investor standpoint with
4 issuers. And we have had over the last couple years several
5 times when issuers would say that they couldn't answer our
6 questions, for example, because of this market advisory.
7 So all to say that, while mostly we've seen
8 positive developments, we do think there's a long ways to go
9 and certainly advisories such as that one were -- sort of
10 did not assist with the issue.
11 MS. MITSUI: Thank you. From my perspective,
12 first of all, I concur with the comments of the previous
13 panelists, in that there have been incremental improvements
14 in the municipal disclosure marketplace and improvements in
15 EMMA and the use of EMMA are very, very helpful.
16 I just want to mention a couple of very, very
17 recent kind of market dynamics that have affected the status
18 of municipal disclosure. One is the current supply and
19 demand dynamics in the marketplace. Demand for tax-exempt
20 bonds has surged, in part due to recent tax law changes that
21 are limiting the state and local income tax deductions for
22 some investors. In demonstration, last week marked the
23 fifty-seventh week in a row of cash inflows into municipal
24 bond mutual funds, a record. And in 2019, industry cash
25 flows exceeded $100 billion, another record.

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1 Meanwhile, the supply of tax-exempt bonds has not
2 kept up with demand, as municipal issuers can no longer
3 issue tax-exempt bonds for advance refundings. Furthermore,
4 favorable conditions in the taxable bond market are leading
5 many issuers to replace their tax-exempt bond issues with
6 taxable debt instead.
7 These supply and demand pressures have resulted in
8 record low interest rates and highly compressed credit
9 spreads. The demand for bonds is almost insatiable and
10 investors are purchasing bonds that have little yield
11 differentials between high quality or lesser quality
12 credits. And it's really essential for us in this kind of
13 environment to have accurate and timely financial
14 information to differentiate one credit from another.
15 Secondly, another trend in the marketplace is the
16 prevalence of private and bank-held debt. The growth of
17 privately placed debt by municipal borrowers is well known
18 and, in fact, led to significant improvements in continuing
19 disclosure requirements through last year's amendments to
20 SEC's 15c2-12. With these amendments, it's clear that a
21 borrower must disclose material new private loans incurred
22 after a bond issue and disclose the material terms of these
23 new loans and events under such loans that reflect financial
24 difficulties.
25 What is less well understood, however, is that

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1 even many primary bond offering documents are missing the
2 full picture of a borrower's private loans and bank
3 obligations. Also missing from many primary offering
4 statements are details of the financial covenants and other
5 terms associated with these obligations. Further, ongoing
6 performance of the borrower under these loan covenants are
7 routinely disclosed to the private lender or bank but not to
8 the investing public.
9 This information asymmetry has resulted in several
10 cases of credit deterioration that has caught public
11 bondholders by surprise, even though the information
12 signaling such credit deterioration has been prepared and
13 disseminated to certain lenders. Again, enabling more
14 timely, easily accessible and robust disclosure is
15 essential, given the current supply and demand dynamics in
16 the municipal securities market and the existing information
17 divide between public bondholders and bank or private
18 capital providers.
19 MS. MARTIN: Thank you for that perspective.
20 Turning to the issuer side, Giedre, what does ongoing
21 disclosure look like for you as a large and frequent issuer
22 of debt? And then, Emily, maybe you could comment on other
23 types of issuers, as well, that don't exactly have the same
24 profile as Giedre's firm does.
25 MS. BALL: It is an ongoing task as part of debt

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1 management. It's not a primary task but it's just as
2 important as making debt service payments. I joined muni
3 field in 2014, at the time when the MCDC initiative was
4 announced. So I was in the midst of all of the disclosure
5 requirements, educational webinars, issues that resulted in
6 the initiatives. I followed some of the cases that had
7 enforcement actions and understood the seriousness of
8 compliance. And I think most of the issues do understand
9 that. And undergone through extensive underwriter due
10 diligence during that time.
11 I drafted continuing disclosure policies and
12 procedures. I created investor relations page. I improved
13 information access. And while we provide a lot of
14 information on a voluntary basis, the new additions that
15 took place last year to 15c2-12 that added financial
16 obligations and financial distress, that just added another
17 additional layer of vigilance to reporting and internal
18 procedures.
19 So our organization, regardless of continuing
20 disclosure requirements, had a culture of transparency. And
21 our financial reports, our board agendas, our interim
22 financials, current and historical, they are all there,
23 available for investors to analyze. And we do constantly
24 hear from the bondholders that it is a value that they see
25 when we go into the issue.

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1 Now, as a large and frequent issuer, we do have a
2 luxury of having an in-house counsel, bond counsel,
3 disclosure counsel. Also a disclosure dissemination agent,
4 which are at our service any time to help us out with any
5 material events or voluntary disclosures if we have any
6 issues. And because we are in the market at least once a
7 year with large issuances, we are constantly having dialogue
8 with our investors and we are aware what information they
9 want and we appreciate the relationship that we have.
10 And while the market is yet good, we do still want
11 to make sure that subscription of our deals is very large,
12 which then results to compressed spreads. Especially, we
13 want to have that relationship and investor participation
14 when the market is not good, because that is when we would
15 really want to see the participation.
16 So that's the extent of disclosure and what that
17 means to us as a new and frequent issuer.
18 MS. MARTIN: Emily, particularly on resources, I
19 think we would be interested in hearing what type of
20 resources some of the smaller municipalities have.
21 MS. BROCK: Sure. Obviously, what works for
22 Giedre and the Airport Authority doesn't work for a school
23 district, might not work for a toll road, might not work for
24 water/sewer, lease revenue, et cetera, et cetera. I mean,
25 there's a lot of diversity in the municipal bond market. I

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1 think we all know that and can appreciate that.
2 But I think what Giedre highlights is that, you
3 know, she did mention, hey, I'm lucky enough to have in-
4 house counsel. There are some, you know, issuers who have
5 to make tradeoffs, tradeoffs of a cost/benefit, right? So
6 as a small school district, can I afford one more teacher or
7 do I need another analyst in here to do additional
8 disclosures to the market?
9 In their perspective, in the debt community's
10 perspective, through the public market process, issuers and
11 investors come together, again to define a tradeoff for a
12 mutually agreeable tradeoff, between yield and timeliness or
13 thoroughness of annual disclosures under their CDA. And,
14 you know, after reading the concept paper for this panel, we
15 would argue that noncompliance with your CDA does carry
16 significant consequence.
17 As an issuer organization throughout, despite
18 large/small varieties of issuers, we have created these best
19 practices that can speak to all types of issuers. But one
20 thing I wanted to kind of follow up on is 15c2-12. 15c2-12,
21 at least the most recent amendments, Amendment 15 and 16, we
22 might argue that the Christmas tree is highly decorated at
23 this point and we're good with the -- we're good with the
24 ornaments.
25 But the more that the SEC was able to reach out

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1 into the organization and to issuers and to other industry
2 participants to create a smooth transition for those
3 amendments 15 and 16 created an environment where we are
4 providing more disclosures to the issuers. And it also
5 created, I think, a way for the industry to come together to
6 find workable solutions to create more disclosures.
7 The other difference between 15c2-12 and what the
8 corporate market works with is that we have 10 days to
9 comply with those material events. So we have a 10-day
10 ticker that occurs that creates this sort of really quick
11 turnaround of information from the issuer to our investor
12 through the notion of 15c2-12.
13 As I said before, our best practices really do
14 concentrate and drill home another key point that we've
15 heard from the Securities and Exchange Commission, is the
16 establishment of policies and procedures. It's not just do
17 this, it's how might we be able to establish in the norm of
18 our operating, to create an enterprise that is a healthy
19 flow of information from municipal securities and the
20 credits that our investors invest in. So in a sense, we're
21 trying to make sure that there is a distribution of
22 information that allows for a healthy market.
23 MS. MARTIN: Thank you. Akiko, you touched on
24 this a little bit in your earlier remarks. But why is it
25 important for you to have this type of information on a

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1 timely basis? And the question would also be posed to
2 Hannah as well.
3 MS. MITSUI: Any effective and efficient financial
4 market is dependent not only on the availability of current
5 information but on readily accessible information and
6 information that results in a level playing field for all
7 investors. The need for current, readily accessible and
8 equal disclosure is perhaps even more important in the
9 municipal market, due to the sheer number and complexity of
10 municipal issuers, as we've heard here before, and the
11 variety of debt instruments, security types and terms even
12 among the debt issued by an individual issuer.
13 While much attention is given to disclosure in
14 primary market deals, a significant amount of trading
15 activities occurs in the secondary market. It is here in
16 the secondary market where I as an analyst often face
17 greater difficulty in determining the fair value of a
18 security just due to the lack of current, accessible and
19 robust information. Information may be available but buried
20 somewhere on an issuer's website, which may not be
21 accessible within the time frame a bond is offered for sale.
22 If I am aware of bank debt or privately placed
23 debt of an issuer, I rarely know whether the issuer has been
24 in compliance with terms and conditions of that debt. Even
25 if I do know that the issuer is in compliance, it is

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1 typically only because the issuer has disclosed this
2 information in a footnote to a financial statement 150 to
3 180 days after the fiscal year end. Further, that
4 information is only provided as a binary outcome of being in
5 compliance or not.
6 In contrast, a bank or private lender will likely
7 have more current information and fuller information. For
8 instance, a bank or private lender will know if an issuer's
9 debt service coverage ratio was five times or just 1.21
10 times against a 1.20 covenant in their loan document. And
11 they will likely know this within 30 to 60 days after the
12 covenant's measurement date. Whether at five times or 1.21
13 times, these covenant calculations are material to bond
14 investors who should know on a current basis the distance a
15 borrower is to violating a bank covenant.
16 Without having parity disclosure for parity debt
17 that is current and readily accessible, preferably on EMMA,
18 the secondary market for many municipal securities suffers.
19 This leads to liquidity premiums on primary market deals,
20 particularly for smaller, less well known borrowers with
21 infrequent primary bond offerings.
22 MS. SULLIVAN: I would agree with what Akiko has
23 said. I would just add that if we back up for a moment and
24 think about generally who is supplying the lending in the
25 municipal securities market, you know, it's a lot of retail

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1 investors. And I know that the SEC, when it does think
2 about regulation, thinks about the retail investor who might
3 be a little bit less sophisticated as far as not having a
4 team of researchers like we do at Fidelity who can devote a
5 lot of time to trying to dig up information on a particular
6 bond offering or issuer.
7 And I think that's important to think about. But
8 also for us, even as a large institutional investor, you
9 know, we take our job of investing our shareholders' funds
10 very seriously. We have fiduciary responsibilities. And
11 part of that, which we take very seriously, is to really
12 diligence the bonds that we buy for our mutual funds, not
13 only in the primary market but also in the secondary market.
14 And in order to execute that duty faithfully, we really have
15 to have that disclosure. Again, not only at the initial
16 offering but throughout the life of us being able to hold
17 those bonds. And if we're not getting disclosure or if
18 we're not aware of all the information, that impacts not
19 only Fidelity but certainly our shareholders as well. And
20 that becomes very important to provide issuers with
21 liquidity in the secondary market as Akiko focused on as
22 well.
23 MS. MARTIN: Thank you.
24 I will move to the recommendations that we put
25 forth to FIMSAC today. They are characterized into, I

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1 guess, three buckets, as Elisse quite nicely pointed out.
2 And there are five of them.
3 First would be, from a legislative standpoint,
4 number one, provide safe harbor from private liability for
5 forward-looking statements made by municipal issuers which
6 satisfy certain conditions. Two, mechanism to enforce
7 compliance with continuing disclosure agreements, the SEC or
8 GASB or whomever else.
9 The second bucket would be regulatory, which those
10 would be twofold, one to explore ways through which the SEC
11 can make disclosure deadlines for annual financial
12 information and audited financial statements more certain
13 and predictable. Importantly, solicit public comment on
14 potential need for and approaches to establishing a
15 disclosure framework for municipal issuers.
16 And then finally, last but certainly not least, I
17 would put one of these recommendations in the educational
18 bucket, which would be, raise awareness regarding the
19 potential consequences of providing less timely and less
20 robust disclosure.
21 Giedre and Emily, what are your reactions to these
22 recommendations?
23 MS. BALL: So I do recognize that the Commission
24 has long been concerned with the disclosure in the primary
25 and secondary markets. And this is definitely deja vu for

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1 Elisse from 2012. And I do hear what investors are saying
2 loud and clear, okay? But I am also very much aware of the
3 complexities of the issuers and issuer diversity.
4 And so I am very appreciative that the issuer
5 voice has been considered in the subcommittee deliberations
6 and I think we've made some concessions along the way.
7 So let me walk through each of the recommendations
8 and what I think and which ones I support and which ones I
9 do not.
10 Since the recommendations have been made available
11 last week, which is a very short period of time, I've heard
12 numerous concerns from issuers, grave concerns, especially
13 when it comes to additional statutory authority. It is
14 perceived as opening up a Pandora's box to eroding the Tower
15 Amendment, regardless of what's being said that that is not
16 the case.
17 So what are the assurances that would be given
18 that this authority that is being sought after, to what
19 extent it's going to be taken? And is it going to be really
20 limiting one?
21 Now, as far as the first recommendation for
22 creating a mechanism for enforcement action, so Elisse
23 mentioned that CDA is a private contract between the issuer
24 and underwriter, underwriter's counsel. It's a negotiable
25 contract. Now, if those obligations are not met, the issuer

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1 is required to file failure to file. And that is being
2 noted in the primary offerings for the next five years. So
3 there is some impact of not doing anything and violating
4 your CDA obligations.
5 I understand that SEC seeking to enforce only what
6 the issuer has obligated to do. This is not prescriptive of
7 anything else, right? Now, but when I think about my
8 situation, I have policies and procedures in place. But
9 miscommunication happens, there's a turnover in staff.
10 Things happen once in a while. And if I'm slipping one
11 time, is this a gotcha moment for me that's going to have a
12 severe impact in the market, right? How severe this
13 enforcement action may be? And really, having that slipup,
14 would that be more of a harm to the issuer than benefit to
15 the investor in the end of the day?
16 Moving on to the second recommendation, which is
17 providing safe harbor, but through seeking additional
18 statutory authority. Now, safe harbor for forward-looking
19 statements to the issuers, it is a favorable thing. But
20 that is mainly related to the primary offering, right? I
21 think what the issuers would prefer more is the safe harbor
22 for interim, unaudited information, to encourage disclosure.
23 Knowing that they provided that in good faith, lacking of
24 negligence and willful intent to defraud, I think that would
25 be more beneficial.

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1 Number three, which would be regulatory and making
2 CDAs more date specific. Now, we -- we've surveyed some of
3 the issuers and none of us are really aware how prevalent
4 this language is in the CDAs. I think most of us have date-
5 specific CDAs that you will be reporting audited financials
6 by, you know, 120 days, 150 days, whatever you decided in
7 the contract, right? So however, we do understand the
8 concern of having the vague language and that is something
9 that I wouldn't oppose. So I can support this
10 recommendation.
11 Four, the subcommittee during deliberations
12 recognizes that these new disclosure requirements may have
13 significant impact on the market. So if, for example, a
14 smaller issuer can access market through bank loans or
15 private placements instead of going to the capital markets
16 and, you know, through the arduous disclosure requirements,
17 I think that may be where the market may shift. You know,
18 there may be less demand because they will be looking for
19 other venues to get those funds.
20 I do like the fact that we think that the SEC
21 should be seeking public comments and engaging everyone in
22 the industry. Because in the end, I think it's always
23 better to have, instead of a mandate, market participant
24 based solution. That's just always a better result,
25 everyone agreeing to what they need to do, instead of a

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1 mandate that could potentially have unintended consequences.
2 And when we talk about issuers, we are talking
3 about public funds, right? Like how public funds could be
4 better used, is it just extra reporting or would you rather
5 put those funds to some other uses.
6 We did talk about the framework. While this is
7 something that we have deliberated and initially thinking
8 that I've opposed the notion that the framework should be
9 one size fits all, that's knowing the complexities of each
10 issuers, different credits, that's not the case. So here we
11 recognize that it has to be taking into consideration
12 everything, that issuers are complex entities,
13 municipalities are.
14 So the last recommendation is raising awareness
15 and I think that's the key one. Education is the key. We
16 need to reach out to really grassroots. We need to reach
17 out to the small issuers who are infrequent in the market
18 and that's probably causing the biggest issues for the
19 investors. I don't think this is a market widespread issue.
20 I don't think issuers -- I would say -- I mean, I can't
21 really quote percentages, but I think this is not the
22 majority of the market that you are facing these disclosure
23 issues.
24 And also municipal credits, I mean, how fast do
25 they deteriorate? That's not -- it's not overnight, right?

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1 Through 15c2-12 disclosures, we are already signaling,
2 through material event notices we are signaling the credit
3 status, right? So you being taken by surprise, to me, it's
4 just hard to comprehend.
5 But either way, number five, raising awareness is
6 -- definitely, that's something --
7 MS. BROCK: I would say ditto on everything that
8 Giedre just said. It seems to me, too, that the way that
9 the recommendations are listed, to Giedre's, I think, key
10 point, education is key. And yet, that's the last
11 recommendation. If we could start there and then consider
12 what the next steps are, I think that GFOA and the industry
13 would gladly rally behind your recommendations, if we start
14 at education first.
15 One thing I want to add on to Giedre's points is
16 that the time frame based on obligation, the time frame
17 recommendation, I think it's the third bullet point, we're
18 going to talk about this later but GFOA has led a disclosure
19 industry workgroup. We have 10 organizations, we have
20 analysts, we have treasurers, we have obviously issuers.
21 But we also have SIFMA BDA participating in this group.
22 Recently, we have come together to address again, just as
23 you're recommending here, just as the subcommittee is
24 recommending here, sort of categorically thinking about what
25 are the disclosures that might be good out of each one of

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1 those different types of categories. We're talking about
2 separating revenue bonds from general obligation bonds, size
3 of issuer, possibly like water from city. So that there is
4 an opportunity to clarify and open up a dialogue between the
5 investors and the issuers of what might be most helpful in
6 terms of disclosure, categorically. But also in this
7 report, what we're looking at is not just what would be good
8 but how could an issuer prepare that information. So
9 looking at process and product.
10 I think, in a way, it allows for a solution, an
11 industry solution to provide more information that's based
12 on dialogue very specifically. But I would say, too, just
13 to elevate from the specific recommendations, when Giedre
14 and I were doing our weekend work, we called as many issuers
15 who would answer my cell phone call. So probably spoke with
16 a couple dozen issuers to try to get a sense of how they
17 felt about this. And most folks, I would say, kind of left
18 the conversation scratching their heads.
19 I think one of the challenges that we have in the
20 issuer community is we need to have a better -- we would
21 like to have a better definition of the policy problem here.
22 What is the policy problem? Is there a limited extent of
23 this problem and, if so, how can issuers help to identify
24 the problems and work with the investor community, work with
25 all of the industry participants to help to triage, to help

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1 the problem -- those who are having problems or experiencing
2 problems communicating their financial information and
3 providing them resources, best practices, products.
4 Because when the industry comes together, we're
5 convinced that at least we have a way to sort of reinforce
6 from an industry perspective, us here at this table, but
7 from a deal perspective every single issuer and how they
8 address their CDAs as they enter into those agreements at
9 the ground level.
10 Adaptability and flexibility is what industry
11 solutions come up with. Mandates do not enhance
12 adaptability or flexibility in a market.
13 More problematically, instead of it being just a
14 head scratcher, most of our constituents were saying, you
15 know, if there is a mandate, if there is uncertainty on how
16 I can provide this information at least effectively, I'm
17 going to look at other ways to issue capital, I'm going to
18 look at other ways to fund infrastructure. And it might not
19 be in the municipal market, it may be different ways to
20 finance capital. It's hard to imagine this logic in a world
21 where infrastructure is such a key priority for state and
22 local governments across the country right now.
23 MS. MARTIN: I'd love to hear from the buy side
24 perspective. Hannah and Akiko, what are your reactions to
25 the recommendations that were put forth?

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1 MS. SULLIVAN: So first of all, I want to give
2 credit to the subcommittee's efforts on this matter, and
3 FIMSAC as well for recognizing that this is an issue that
4 does still need attention, for the reasons we've all
5 discussed up here. There are really unique challenges in
6 the municipal market, not the least of which is the limits
7 on regulatory authority. And I think we would all agree
8 that a one-size-fits-all approach just doesn't fit neatly in
9 the municipal market.
10 We generally agree with the recommendations. We
11 would acknowledge that each of them requires additional
12 action by the SEC in order to actually be implemented so
13 that it's really difficult to predict exactly what the
14 impact is until we better understand how the recommendations
15 may materialize, as far as changes to the current disclosure
16 regime. But that being said, we would note and we were
17 disappointed that, for example, the second recommendation
18 really speaks to forward-looking statements from municipal
19 issuers but doesn't include specifically interim financial
20 disclosure. And so we agree with Giedre that that is a
21 missed opportunity and would be a positive thing to include
22 if possible.
23 And we generally think that there is room for
24 improvement in the disclosure regime. Organizations such as
25 the NFMA, which is the National Federation of Municipal

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1 Analysts, have posted on its website for years suggested
2 disclosure parameters for the issuer community. And
3 generally speaking, it's with very mixed results that
4 issuers implement those recommendations on disclosure.
5 So we do think that there is action that needs to
6 be taken and we applaud the efforts in this area.
7 MS. MARTIN: Akiko.
8 MS. MITSUI: I concur with Hannah. Most of the
9 recommendations seem to be a step in the right direction.
10 In particular, I concur that a safe harbor for forward-
11 looking statements should include interim financial
12 statements and quarterly financial statements that are not
13 necessarily forward looking but unaudited. Removing
14 contingency language from promised dates for final
15 disclosures in a CDA seems to be very straightforward. I
16 would endorse that wholeheartedly. And, as other panelists
17 have said, the SEC's interest in gathering more information
18 and finding market-based solutions that may address
19 different borrowers' needs and investors' needs for those
20 borrowers in terms of disclosure is a welcome step.
21 I would like to note though that the idea that
22 continued conversations just by market participants would
23 lead to a significantly improved municipal disclosure regime
24 is probably a little bit -- is a hopeful but probably
25 unrealistic guidance. And I will just point back to the

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1 need for the SEC to step in to add the two material event
2 disclosures, number 15 and 16 last year to point to a real
3 need for investors to have information about additional
4 lending that has been taking place among our borrowers. And
5 it wasn't really until the rule was amended to add material
6 event number 15 and 16 that it was clear that really needed
7 to be disclosed, and still only disclosed on a suboptimal
8 basis.
9 And the additional comment saying that, you know,
10 municipal borrowers' credit quality moves slowly and we're
11 not caught by surprise is maybe generally true. But if you
12 think about what the covenant issues with the private loan
13 market has introduced, it has introduced real event risk to
14 the municipal market. And just last week, there was yet
15 another case of a borrower in our portfolios that violated a
16 bank covenant that was not disclosed, the performance of
17 which was not disclosed to the municipal bondholders.
18 Which, when that happened, resulted to a downgrade to below
19 investment grade.
20 So the current market structure does introduce an
21 element of event risk that disclosure would be extremely
22 helpful.
23 MS. BALL: Akiko, I want to just make one more
24 statement. When you say you want to see the material
25 provisions in the private bank loans and private debt,

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1 that's GASB 88 -- 2019. That should be all in the --
2 MS. MITSUI: And there's municipal entities that
3 are also subject to FASB and I think I wanted to make sure
4 that it's clear that the continuing performance under all
5 the covenants should be disclosed on a parity basis to
6 investors as well as to the banks.
7 MS. MARTIN: I have one more question before I
8 think we should open it up to the broader FIMSAC in the
9 interests of time.
10 Elisse, as an active member of the subcommittee,
11 you know we considered a variety of alternatives when we
12 were putting together this document. Would you mind
13 commenting on what the alternatives were and why, after much
14 debate, where we thought we came out was a much more
15 balanced view?
16 MS. WALTER: I can certainly do the first. Not
17 sure about the second but I'll try.
18 I myself support the recommendations but I'm quite
19 disappointed in them, as you know. I feel that every time
20 we discussed this issue, we'd turn around and come back to
21 the same discussion. And to the extent that market
22 participants feel this can be cured by education, one of the
23 things that the discussion here shows is there's a
24 tremendous amount of education that's going on today, some
25 from the SEC, a lot from the MSRB, the GFOA itself, the

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1 NFMA, NABL. There are all kinds of parties putting
2 educational materials out to the marketplace and that has
3 not solved the problem.
4 So I think it's time to take stronger action than
5 that. And the primary alternative that we focused on is
6 that we talked about actually recommending, as the 2012
7 report did, that legislation be sought now to give the
8 Commission the authority to solve this problem.
9 I want to emphasize that that places a big burden
10 on the Commission. First, it won't be so easy to get that
11 legislation, so it's not going to happen tomorrow. And
12 second, getting the authority does not tell the Commission
13 how to exercise that authority. And there would be a lot of
14 work that would need to be done by regulators, market
15 participants and the like, to decide how that authority
16 would be exercised. And I don't think anyone, including
17 myself, feels that it should be exercised on a one-size-
18 fits-all basis.
19 I would like to point out that, when we talk about
20 interim disclosure and keeping people up to date, one of the
21 things that really came out loud and clear through investor
22 participation in the 2012 field hearings is that maybe this
23 is still on a true retail level more of a buy and hold
24 market than other markets. But it is not completely a buy
25 and hold market. And investors told us that if they go to

1 sell a municipal security, they don't have a clue as to what
2 it's worth. So if you want to buy it and hold onto it
3 forever in good times, you can more or less count on that
4 being okay.
5 But the other thing to point out is that
6 regulation has to cover the bad times as well as the good
7 times. And that is bad times in general, when the market
8 goes south. And knock on wood, that won't happen ever. But
9 we know it will in some point in time. And also bad times
10 for a particular issue, like the one that was just
11 highlighted now.
12 So that investors deserve to have that
13 information. And if the Fidelities and the Vanguards, among
14 two of the most capable institutions I'm aware of in the
15 marketplace, don't feel they have enough information, what
16 about mom and pop? They certainly don't have the
17 information.
18 So I think it's important that we go ahead at
19 least with the recommendations we have here. But I don't
20 want to see us go through a decade by decade, okay, let's
21 start with discussing the issue more and putting it more in
22 the public domain. I think the time has come now to really
23 take further action than that.
24 MS. MARTIN: Would anyone like to respond to those
25 comments before we open it up to the broader FIMSAC for



1 questions?
2 MS. BALL: I think we can all agree that we are
3 wanting to see an improvement in the market. It is just
4 what is the way to get there? And our desire would be to
5 have a carrot not a stick. And that carrot could be through
6 credit rating agencies, incorporating that, addressing that
7 with a rating process, or leave it up to, you know, a free
8 market process where investors vote with their feet, saying
9 that I am not going to purchase these bonds. Which, yeah,
10 when there is so much demand for munis right now even that's
11 not the case.
12 But let's raise awareness that the issuers would
13 face consequences for their nondisclosure when the market is
14 not there, when demand is not there.
15 And really, when you think about municipalities,
16 you have to remember that these organizations are running
17 schools, public safety, airports, roads, water facilities.
18 And they are doing that with limited resources. So when you
19 add a mandate to do -- to have them provide interim
20 financial statements, at what cost that's going to be? What
21 does that mean to their budgets?
22 And honestly, I guess we need to have a
23 discussion, what information is being requested from the
24 issuers. Because municipalities are preparing their
25 budgets.



1 Now, is it really -- how much value it is for you
2 to see that, oh, this month, there was 75 percent of
3 property taxes collected, you know, budget to actuals? We
4 need to define what that information is that you are
5 requesting. Because having full-blown financial statements
6 on a periodic basis may not be feasible for everyone.
7 So I would just caution that when thinking about
8 the framework and requirements, it's really very unique to
9 each organization.
10 MS. MARTIN: Emily, did you want to comment as
11 well before we open it up?
12 MS. BROCK: Again, I would say ditto to everything
13 that Giedre just said. Again, I think it kind of goes back
14 to defining the problem. How might we better help the
15 issuer community define the problem, because I think that
16 exercise itself might help us come to a more workable
17 solution.
18 MS. MARTIN: Okay. Michael, do you want to open
19 it up to the broader FIMSAC?
20 MR. HEANEY: Thank you, yes. Thank you very much
21 again for your participation. This is another hefty topic
22 and a lot of eye-opening aspects to it. So we appreciate
23 it.
24 Kumar, why don't we start with you?
25 MR. VENKATARAMAN: Thank you, Michael. Thank you



1 very much to the panel for a very, very informative session.
2 I've learned a lot.
3 I have two questions. The first is to the buy
4 side participants. The last recommendation says that there
5 may not be significant differentiation in the terms of
6 yields from investors for municipal issuers who have little
7 to no interim financials versus those who provide a more
8 robust interim financial. So from the buy side perspective,
9 is this really the case? Do you think that these
10 disclosures are priced as an investor when you participate
11 in the primary process? Is this something that you take
12 into account? And, you know, do these issues trade
13 differently?
14 And my second question is to Elisse and possibly
15 Rebecca and this relates to the first recommendation that we
16 have with respect to the SEC be given additional statutory
17 authority.
18 So with respect to these continuing disclosures,
19 is another way for the SEC to reach the objective through
20 suitability requirements as part of -- you know, for
21 financial advisers who are handling investor portfolios?
22 And whether lack of sufficient disclosure may be viewed to
23 be a risk class that should be taken into account? That's
24 perhaps another way in which investors can be protected.
25 Thank you.

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1 MS. SULLIVAN: Thank you for the question. It's a
2 great one because it's something that I think, if there was
3 a very clear way to measure the difference in yield based on
4 disclosure, this problem probably wouldn't be as thorny as
5 it is. And it's nuanced.
6 From our perspective, we definitely walk away from
7 or want to be paid more for deals that have poorer
8 disclosure. But how that translates to sort of the market
9 and yield impact, it's very hard to say.
10 I would say, thinking about it in this type of
11 market where spreads have compressed really across different
12 credit quality even, it's very just hard to measure and hard
13 to say that there is a big yield impact generally. But what
14 we really worry about is the idea that it is going to take a
15 market with very different technical factors to show exactly
16 what the problem is here. And that's something that I think
17 is bad for the municipal market generally. No one wants a
18 significant default. No one wants a, you know, sort of fire
19 sale of certain low credit quality issuer bonds, and no one
20 wants to be holding the bag with bonds that just don't have
21 great disclosure or that we didn't get disclosure in time.
22 And so the real advantage, in my mind, of these
23 recommendations is it's an attempt to do something
24 proactively before the market -- before it's too late,
25 effectively.

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1 Another aspect of the yield difference, and this
2 is something that Elisse touched on, these bonds don't
3 always trade as frequently as, say, a corporate bond. And
4 because of that, it's that much harder to measure yield
5 because they might be in a single portfolio for years before
6 trading. So that all presents a lot of difficulty, sort of
7 putting a particular yield impact on disclosure.
8 MS. MITSUI: I also concur. There are many
9 situations where we demand greater disclosure and we get it.
10 And there are some situations where we demand better
11 disclosure and we don't get it.
12 There are, as we've touched on several times here,
13 a variety of different borrower types in the municipal
14 market with different sectors, from hospitals to state
15 governments and even more. And some have very complex
16 projects risks or debt structures, more volatile cash flows
17 or just lower credit quality. And we do participate in many
18 discussions regarding continuing disclosure agreements and
19 sometimes do have to draw the line and not participate in a
20 deal or demand that the yield is a certain price.
21 But the current market dynamics do mask many, many
22 imperfections, both in terms of disclosure as well as even
23 credit quality. So it's a very difficult market to be
24 participating in.
25 I will also note that we do take action and it

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1 doesn't necessarily turn into a yield differential. But we
2 are advisers as well to our money market funds. And under
3 the money market fund guidelines, we have a very strict
4 mandate to independently determine that each security held
5 in our money market funds represents minimal credit risk,
6 both at the time of the issuance and on an ongoing basis.
7 So if there is news in the marketplace that causes
8 us to question the safety and soundness of a money market
9 security, absent the continuing disclosure from the issuer
10 we may be forced to sell those securities from our money
11 funds, not because they are not minimal credit risk but
12 simply because we don't have the information to prove that
13 they're minimal credit risk. That hurts. That hurts.
14 Those situations are rare and -- but that hurts our
15 shareholders and it raises reinvestment risk in our funds
16 and increases transaction costs.
17 So what I'm saying, too, is ironically more
18 frequent interim disclosure, although it's really necessary
19 sometimes with the more low quality borrowers, is also
20 necessary for higher quality municipal issuers, particularly
21 those that issue money market eligible securities. So it's
22 not always in the yield. But we do take action. But this
23 market is masking a lot of the effects.
24 MR. HEANEY: Thank you. Let me quickly just turn
25 to the phone and see if John or Suzanne, Matt, Lee, if

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1 anyone has questions on the phone before I go back to in the
2 room.
3 MS. SHANK: Mike. I was going to ask a question
4 about masking of differential disclosure practices and I
5 think the buy side answered that for me.
6 MR. HEANEY: Thank you, Suzanne.
7 MS. WALTER: Michael, can I take a shot at Kumar's
8 second question? I want to apologize for my voice. It's
9 going in and out for some reason.
10 It's a very interesting question and I haven't
11 thought about it a lot. But let me give you a preliminary
12 reaction since I no longer have to worry about getting
13 tagged for speaking for the SEC.
14 I think that under a suitability or best interest
15 analysis, that works better on the upside than the downside,
16 particularly under best interest. I mean, if I have an
17 issuer that is -- has a history of consistently making more
18 prompt disclosure, putting out interim information that's
19 available and I'm looking at a choice for an investor, I
20 think that there would be a real best interest question if I
21 chose the one that was not the better.
22 On the bottom side, on the downside when you're
23 talking about, well, have a recommended something that's not
24 suitable, I think it becomes much more difficult because
25 it's one factor among many. And given the unique nature of

1 municipal securities, and here I'm really talking from a
2 retail customer vantage point, the tax issues and the like,
3 I think the more likely result would be to have a
4 conversation in which the investment professional said, I
5 really think you ought to have a security that looks like X,
6 Y and Z and here's one that looks perfect. But you should
7 know, either there's a bad track record on disclosure or
8 there's no track record. And it would -- you would probably
9 end up in the same place with the same problem.
10 I also have a little bit of an issue in that we
11 have pushed really hard on investment professionals for what
12 essentially is an issuer issue. And I think at some stage,
13 we need to come up with a more elegant solution that really
14 is a direct line between the people who have the questions
15 and the people who are selling the securities.
16 MR. HEANEY: Thank you, Elisse.
17 Larry.
18 MR. HARRIS: Elisse, that might be a great
19 introduction to my comments. First of all, I support the
20 recommendation.
21 But if we're going to be seeking statutory
22 authority, I think we should consider the problem in a more
23 broader sense. The general principle of risk management,
24 the first principle, whether it's in the construction of
25 ships or cars or of systems, and including systems like muni



1 finance, the first principle is always that the people most
2 capable of managing risk should be the ones responsible for
3 it. And the problem we have is that we're using a market-
4 based system to try to manage risks where we have tens of
5 millions of investors and more than a hundred million
6 issuers. And that makes it very, very difficult.
7 The potential solution to this problem is to
8 create state bond banks. And there are a few states that do
9 have them. Through a state bond bank, then the
10 municipalities obtain their finance from the bank and the
11 bank would be the one that goes to the market. It doesn't
12 have to be for every entity in the state. And the banks --
13 states could have different types of banks for different
14 types of issuers.
15 But in concentrating or putting -- creating this
16 type of intermediary, we could do -- we could go a long way
17 to solving many, many problems in the muni finance market.
18 And so my suggestion is that if the SEC is going to be
19 asking for statutory authorities, that he SEC and perhaps
20 others, and perhaps Congress as well consider carefully what
21 are the incentives and disincentives associated with the
22 formation of state bond banks. It's possible that through
23 the tax laws, we could provide strong incentives to create
24 those banks that would ensure that people local to the
25 municipalities have the responsibility for dealing with so



1 many of these issues and, at the same time, decrease the
2 total number of issues that are coming to the market.
3 We're talking about regulations that are going to
4 impose obligations on the financial managers of entities
5 like, you know, the Riverside Mosquito Abatement District.
6 If such a thing even exists. I'm sure somewhere in the
7 country, there's a Riverside. Perhaps even in California.
8 So those financial managers have to know an awful
9 lot to comply with disclosure requirements and so forth and
10 they have to interact with markets in ways that require a
11 great deal of sophistication. In the end, that's probably
12 just not appropriate. They need to be better protected.
13 And I think the states need to step into this
14 responsibility.
15 And so if we are going for statutory authorities,
16 then we should consider providing that type of advice to the
17 Congress, of course based on whatever we learn. I don't
18 know a whole lot about this, about what are the impediments
19 and the advantages of state bond banks.
20 MR. HEANEY: Thank you, Larry.
21 In the absence of any other comments, I'm just
22 going to make a few myself. Not as FIMSAC chair but as part
23 of this subcommittee or part of FIMSAC. And I am going to
24 echo a couple of the comments.
25 I mean, working with the issuers to make



1 improvements while on the face of it sounds like a good
2 approach, you have to question the incentives right now of
3 the issuers to make material changes. And, you know, there
4 have been many examples in the past, whether it was the
5 banks post crisis or otherwise, where actually mandating
6 change was the only way to get change rolling.
7 So respectful of Elisse's comments that maybe this
8 recommendation should be stronger, I'll echo what I said
9 about the earlier ones. This gets it off on the right foot.
10 And it gets the start to -- and if everyone read Tab C
11 carefully, there's plenty of ways to deviate so this is not
12 one size fits all. The SEC should explore ways on
13 disclosure deadlines. The SEC should seek wide ranging
14 public comment as it relates to some of these changes.
15 This is an attempt to get the ball rolling, to
16 improve a situation that, clearly, if I own a municipal bond
17 and a covenant is defaulted by that issuer to a bank and I
18 don't know, that just seems, in everything we're supposed to
19 be doing, wrong. That's my own two cents.
20 Now I'll put this back up here and ask if I can
21 entertain a motion to vote on the recommendation as it
22 stands and as it was presented, understanding that there
23 could be subject to change.
24 MR. McVEY: So moved.
25 MR. HEANEY: Thank you. Can I ask all members to

1 raise their hands who are in favor of this recommendation?
2 (A show of hands.)
3 MR. HEANEY: All opposed, please raise your hands.
4 MS. BALL: I support partially, so I guess I'm
5 opposed --
6 MR. HEANEY: All abstaining, please raise your
7 hands.
8 And then let me go to the phone, please.
9 Matt?
10 MR. ANDRESEN: Yes.
11 MR. HEANEY: Lee, Suzanne?
12 MS. SHANK: No, as currently presented.
13 MR. HEANEY: Okay. And let me just again check.
14 Lee, are you there to vote?
15 Okay. So the recommendation has passed. It was
16 14, again for the benefit of those on the phone, 14 in
17 favor, two opposed, no abstentions.
18 And again, I want to say the same as I said
19 earlier. This takes a lot of hard work by the subcommittee
20 chairs, to create them, the work with the subcommittees, the
21 panelists who take time to do this. It's a lot of heavy
22 lifting. So Lynn, thank you very much for your leadership
23 in getting this discussion started and getting the
24 recommendation passed. Thank you.
25 We will have a very short five-minute break and



1 then head into our last panel of the day. Thank you very
2 much.
3 (Recess.)
4 MR. HEANEY: All right, let's move into our final
5 panel. And I apologize to the panelists for being a little
6 over and behind schedule here. But we will have a full
7 panel. This wouldn't be the first time we've run over.
8 Let me turn it to Rick McVey, who is chair of the
9 technology and electronic trading subcommittee to discuss
10 this panel concerning internal fund crosses. And I will say
11 it's a topic that many of us have dealt with for many years
12 and it's certainly worthy of discussion here at FIMSAC.
13 Rick.
14 INTERNAL FUND CROSSES PANEL
15 MR. McVEY: Thanks, Michael. Our panel this
16 afternoon will begin to explore some of the challenges U.S.-
17 registered investment companies face when they would like to
18 move a bond position from one advisory client or fund to
19 another advised client. Known as internal crosses, these
20 transactions are limited by the very specific requirements
21 of Rule 17a-7 of the Investment Company Act of 1940, which
22 was first adopted by the SEC in 1966.
23 Given the significant increase in fixed income
24 transparency and realtime data available to determine fair
25 market prices, it is now possible in many cases to



1 independently determine midmarket bond pricing with
2 confidence. Many investment managers believe that the
3 current restrictions on internal crosses should be
4 revisited. Without the flexibility to conduct cross-trades,
5 mutual funds and separate accounts may incur unnecessary
6 transaction costs as well as opportunity costs that can
7 reduce portfolio returns for their clients.
8 Electronic trading solutions for internal cross-
9 trades have emerged in Europe as well as in the municipal
10 bond market here in the U.S. However, these emerging
11 solutions are currently not available to funds subject to
12 the Investment Company Act due to Rule 17a-7. As a result,
13 the technology and e-trading subcommittee of FIMSAC has
14 started a review of the current regulations to see if
15 consensus can be reached to present a recommendation to the
16 full FIMSAC committee at a future date. Given the
17 importance of this topic, we wanted to start today with a
18 panel of industry experts to share their insights on
19 internal crossing with FIMSAC and answer any questions you
20 may have.
21 I would like to thank Lance Dial, managing
22 director and counsel at Wellington Management; Kevin
23 Gleason, senior vice president and chief compliance officer
24 at Voya; Nora Jordan, partner and head of the investment
25 management group at Davis Polk; and James Wallin, senior



1 vice president at AllianceBernstein for joining us today on
2 the panel. I am sure we will all benefit from your
3 comments.
4 So if I could, maybe Lance, you can start out with
5 just a brief description of what we mean by internal crosses
6 and what the benefits might be to the market if more of them
7 were permissible by investment managers like Wellington?
8 MR. DIAL: Sure, happy to do so. My remarks are
9 only an hour and a half long. I know we're running over,
10 but this is an important thing --
11 (Laughter.)
12 MR. DIAL: So cross-trading, as Rick pointed out,
13 clients trade with each other through the common adviser.
14 And this provides a lot of benefits to clients because they
15 can trade at prices that do not include a spread, they can
16 trade at prices that don't include a commission, and they
17 have access to different pools of liquidity. And especially
18 in firms, larger firms like Wellington Management, where we
19 have about half of our trillion dollars in management in the
20 fixed income space, we have over time lots of opportunities
21 to cross clients and save them money. So this is an
22 opportunity to save clients lots of money in transaction
23 costs.
24 So what are the problems? Well, the problems are
25 that crossing does create the potential for abuse. And

1 that's clear because you have an adviser looking at two
2 clients and determining that it's good to sell and good to
3 buy and determining the price. So it's ripe for regulatory
4 attention and we have that regulatory attention in Rule 17a-
5 7. Nora is going to go and give us the details on 17a-7, so
6 that takes the pressure off of me a bit. But I can tell you
7 that there are two main problems with 17a-7 from a mutual
8 fund standpoint.
9 But before we get to that you might ask, that's a
10 mutual fund rule. Why does that impact your entire book?
11 Well, 17a-7 sets forth kind of a gold standard for how to
12 look at crossing. And the themes and principles under 17a-7
13 are incorporated into many advisers' overall crossing
14 platform. So at Wellington, we've incorporated the
15 standards of 17a-7 in our overall crossing policy, so that
16 we look to the same rules for separate accounts and mutual
17 funds. So getting guidance here and getting these
18 provisions changed will be helpful for a broad swath of the
19 market, not just U.S. mutual funds.
20 So what are the two issues? The first issue is
21 17a-7 has a requirement that funds trade at a current market
22 price, which is determined on the basis of reasonable
23 inquiry. In the fixed income space, reasonable inquiry is
24 usually done by reference to three bids and three offers,
25 and that's become more difficult in current markets.



1 The second one is a sleeper issue a little bit,
2 and that is an operational issue. 17a-7 prohibits the
3 payment of a commission but does permit other transaction
4 costs. The ambiguity on this second phrase, other
5 transaction costs, yields uncertainty as to what you can
6 pay. And because of the operational nature and intensity of
7 trading when you're trading multiple clients with multiple
8 custodians, we need the ability to pay a nominal transaction
9 fee to utilize the resources of broker-dealers to help
10 effect these cross-trades.
11 So in sum -- we'll go into more detail in all of
12 these. But in sum, we think this is an opportunity with
13 some targeted regulatory change and attention to realize a
14 lot of savings for investors, both big institutional
15 investors and small mom and pop investors investing through
16 mutual funds.
17 MR. McVEY: Great, thank you. And Nora, maybe I
18 can turn to you to give an overview of 17a-7 and some of the
19 rules that restrict internal crosses.
20 MS. JORDAN: So I'll start with talking about what
21 happens when a registered investment company is not
22 involved. So you have an adviser advising two institutional
23 clients, could be a hedge fund, could be Wellington with two
24 institutional clients, who is not choosing to follow 17a-7.
25 What applies there is the Advisers Act and the Advisers Act



1 is a fiduciary statute. It doesn't have a lot of very
2 specific rules about what you can and can't do in certain
3 circumstances, but there is guidance on it. And so if it's
4 two institutional clients, and let's assume for the moment
5 that one of the clients is not related to the adviser and
6 let's assume that the adviser is going to cross with no fee
7 at all, and those are the only circumstances we're talking
8 about here today, because those other things raise other
9 conflict issues, if you're dealing with your affiliate on
10 one side or there's a fee, and we're not talking about that
11 at all. We're just talking about two unaffiliated
12 institutional clients crossing.
13 And basically, what has to happen is the adviser
14 has to make sure that the trade is in the best interest of
15 both clients and they have to make sure that the price is
16 the most favorable under the circumstances to each client,
17 basically best execution. And that's all that applies. You
18 just have to make sure that it's in the best interest and
19 the price is fair. And of course, people document that.
20 The SEC comes in and inspects and makes sure that -- you
21 know, looks at these cross-trades to make sure they're fair
22 to all clients. And that's kind of the law when it's not
23 17a-7.
24 If 17a-7 applies -- sorry, let me talk about first
25 what happens. How do they make sure it's in the best



1 interest of clients? And that is, they look at an
2 independent pricing source. Right? I mean, it's in their
3 judgment what to do but generally that's what happens. Or
4 they might say, look, I've got an electronic trading network
5 that trades and, in that network, they have safeguards. For
6 example, I've told that network if I'm trading, don't ever
7 cross with my affiliate unless there are two other bids.
8 Or, don't cross if the offers are not within, say, two
9 standard deviations of other securities that are very
10 similar to this security and then they would have a test to
11 do that. But it's in the adviser's discretion to look at
12 how they are trading.
13 MR. McVEY: Just a quick follow-up question on
14 that. What no-action relief has been passed in the past and
15 how does it apply to where we are today?
16 MS. JORDAN: Okay, very little under the Advisers
17 Act. It's really up to the adviser to determine. But in
18 the Investment Company Act, which now we have the Advisers
19 Act, which still applies to the adviser. So all of
20 everything I just said still applies. But now we're going
21 to introduce a registered investment company into the
22 picture. And now the adviser is still subject to those
23 requirements but the Investment Company Act has this rule,
24 17a-7, which gives lots of very specific requirements on how
25 to cross. And those provisions work very well if you have a

1 liquid equity security. But if you do not have a liquid
2 equity security and it's a fixed income security, it's a
3 little unclear how to interpret the rule. And that's for
4 the two reasons that were mentioned by Lance. There's a
5 provision that says you can't charge a commission or other
6 remuneration except for a customary transfer fee. So it's
7 clear you can't charge a brokerage fee, it's clear you can't
8 charge something that's like a brokerage fee, but you can
9 charge a transfer fee. And there's no interpretation of
10 that.
11 And then on the question -- the second part of
12 17a-7 that's the issue is this point of getting these three
13 bids and three offers. And those come through the no-action
14 letters, which I will talk about.
15 In 1992, the SEC, in the context of municipal
16 securities, said, okay, we're going to interpret rule 17a-7
17 to say that if you go out and get three bids or you get
18 three independent pricing services to give you a price, or
19 you do a combination of those two and then you take the
20 average of the three, you can execute, you can do the cross-
21 trade.
22 That proved to be a little unwieldy. And so a few
23 years later, about three years later, the same applicant
24 came in, again in the context of municipal securities, and
25 said, can we just use one pricing service and how about we



1 use the pricing service that we use to value our assets
2 every day? Right? So every day, we have to value these
3 assets, we publish it, we have two funds, the securities are
4 being valued the same in both funds. Shouldn't that be the
5 price we use? And the SEC said, yes, you could do that.
6 Again, municipal securities.
7 And then in 2006, the SEC issued another no-action
8 letter that said, okay, there seems to be some confusion
9 where people think that we're actually requiring that you
10 use the pricing service that was mentioned in the letter.
11 And the SEC made clear, the Staff, that no, you don't have
12 to use that particular pricing service, you can use a
13 pricing service.
14 So we're left with two things. One, all the
15 letters are in the context of municipal securities. There's
16 nothing that says you can do it outside of that. And we're
17 left with this, you must use a pricing service. And that
18 doesn't always work, as we're going to talk about in a few
19 minutes.
20 MR. McVEY: James, maybe I can turn to you just to
21 see what your thoughts are around internal cross
22 opportunities and also how you think about best execution in
23 the context of internal crosses.
24 MR. WALLIN: You know, I echo everything that
25 Lance and Nora have said so far. And, you know, first of



1 all, I think it's important to put it into context. You
2 know, the first point is that the regulators have recognized
3 since at least the sixties that it's legitimate to seek out
4 savings where you can opportunistically on trades. And I
5 think that initially, you know, this rule was adopted at a
6 point in time where you had fixed commissions and commission
7 savings would have been a significant savings to the client.
8 That's no longer the case for equities.
9 But, you know, it's never going to be a huge
10 amount of our volume. And nonetheless, it's important when
11 it's important.
12 So, you know, in terms of ensuring that clients
13 receive best execution, you know, it's very difficult to go
14 out and get three quotes on a lot of fixed income securities
15 because the market isn't there. There are new rules in the
16 MiFID zone, for example, that prohibit you from soliciting
17 quotes and bids for securities that you don't intend to
18 trade.
19 And so while we do cross, we have a process for
20 crossing, it's set up in the way Lance described his, where
21 it sort of plays to the highest or lowest common
22 denominator, depending on how you want to characterize it.
23 And it's unwieldy and it doesn't -- the amount of effort
24 that's involved in executing a cross is inconsistent to --
25 it's inconsistent with our trading flow, which involves



1 thousands of transactions a day and it also is not very cost
2 effective, even though at the individual client level the
3 savings can be significant. And I can give you two examples
4 of that.
5 One is in the muni area where, you know, we see an
6 observable spread on the average of about 55 cents. And if
7 you were to take and put into context, in that context, a
8 $10 million trade and cross it at midmarket, assuming you
9 can determine the market, you could save as much as $27,000
10 per client in trading costs. And, you know, to do that
11 incrementally over the course of a year or across your whole
12 client base, it's not insignificant. It's a measurable
13 benefit to your client and it has no downside.
14 The same thing applies to the investment grade
15 market, where the observable spread is a little higher and,
16 you know, if you had a one and a half point spread, you
17 could save as much as 7,500 per client on a $100,000 trade.
18 But the problem is pricing. And the other problem
19 is working it into our workflow and not having to instruct
20 custodians and do manual processes to get the trade done.
21 So what we think, you know, is appropriate and it's
22 reflected in what Nora and Lance said, is to allow pricing
23 services to be used as the mark to market mechanism for
24 crosses in fixed income securities across the board and not
25 just limit that to municipal securities, number one. And

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1 number two, to allow us to use platforms such as Market
2 Access and others that provide both, you know, recordkeeping
3 and some sort of pricing service input to allow us to do the
4 trades in an efficient manner and alongside other trades.
5 And I will throw a third point into there, because
6 there may be situations where we're sending buys and sells
7 to the market simultaneously for some of the same reasons
8 that we'd be doing a cross. And yet we don't necessarily --
9 we're not fixated on doing a cross because there may be more
10 liquidity in a security, more supply.
11 But we may end up inadvertently crossing or -- and
12 not inadvertently crossing completely unknowingly but having
13 entered a trade into certain like -- again, there is a bid
14 back process that Market Access has which could or could not
15 put us in a position where we end up getting back our own
16 securities. And the issue that we see there, and Nora and
17 Scott and I have talked about this is that, whereas all of
18 the crossing rules -- the rules permitting crossing in the
19 U.S. currently expect you to execute the price at a mid,
20 however you determine that mid, either using pricing service
21 sources or actual bids and quotes, these situations where
22 you're putting your securities into the mix with other
23 people's securities may result in a cross, will according to
24 the rules of the game in these systems still end up
25 executing, having your execution done in the middle of the

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1 bid and ask, and therefore still saving your clients money.
2 It may not be done right at the mid. And that's something
3 that we're -- at least I think we need to seek relief on as
4 well.
5 So did I answer the questions?
6 MR. McVEY: Yeah, and I think a follow up to you
7 or Kevin or Lance, it actually relates to an earlier
8 conversation that we had today about the increasing use of
9 realtime benchmark pricing for transactions. And it was in
10 the context of portfolio trades earlier. But maybe you
11 could talk about the data advancements that give you the
12 tools to be more confident on where an independent midmarket
13 price would be that could give rise to modernization.
14 MR. DIAL: I'm happy to do that. And I'd like to
15 do it with contrast to the SEC's no-action letter that
16 granted the relief to transact in munis. In that letter,
17 the applicant described their process for obtaining the
18 market vendor and what the vendor would do. And what the
19 vendor would do, as described in the letter, come in in the
20 morning, pick up the phone, call a few people, come up with
21 a price and say that's the price. And that was determined
22 to be that's pretty good.
23 Now we have systems, quantitative boxes,
24 computers, robots. We have all the information you could
25 ever want to have about an issuer at your fingertips. We

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1 have a reliable culture of vendor data prices. We have
2 marketplace competition. We have a history of using funds
3 -- our fund using vendors for pricing their NAV. We have
4 oversight mechanisms. We have guidance from the SEC on how
5 to oversee pricing vendors.
6 So the world has come a long way since that person
7 came into their office, picked up the phone and called a few
8 market intel people. And we think that the theory still
9 holds. If you have an independent pricing vendor who has
10 access to all these resources in the business of pricing
11 securities and people pay them, literally, to value
12 securities for them and they are used by the mutual fund
13 industry to price NAVs on which shareholders create and
14 redeem every day, in that case we think that that is a good
15 solid indicator of value. And as you put that again, as
16 we'll talk later, against an evaluation, a best execution
17 evaluation by traders independent of perhaps a portfolio
18 management team, then you can really have the investment
19 protection you need to deal with that inherent conflict I
20 alluded to earlier.
21 MR. WALLIN: Yeah, I mean, if we're not going to
22 let the industry use pricing services for crosses, which in
23 money terms are very small magnitude, we shouldn't be
24 letting -- don't act on what I'm going to say, but we
25 shouldn't be letting them use it for daily pricing. And, of

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1 course, we know that it would be impossible to function as
2 an industry if we didn't.
3 MR. McVEY: On that point on benchmark pricing,
4 there were changes to investment manager capabilities on
5 internal crosses in the E.U. post MiFID II, which we know on
6 our system and others has allowed this type of pricing using
7 an independent benchmark. But do any of you have any
8 experience with that or can you comment on the developments
9 in the E.U. relative to where we are here?
10 MR. WALLIN: Well, I think, you know, a couple of
11 basic points. First of all, there's no bias against
12 crossing in most of the E.U. regulation. There is not the
13 same conflation of trading with a client -- with another
14 client of a manager as being somehow a principal trade with
15 an affiliate of the adviser. So this whole concept of
16 principal trading that we're bound by or, you know,
17 prohibited from doing except under limited circumstances
18 doesn't exist in the E.U. And, you know, it's governed
19 primarily by your client contracts. And we try to encourage
20 clients to permit us to cross where it's jurisdictionally
21 possible.
22 But I think one of the major distinctions is that
23 if you're going to do a cross, they don't want you doing it
24 by direct instruction through a custodian. They want you to
25 do the cross on an established marketplace or crossing

1 mechanism, so that there's an independent record, there's an
2 independent price feed. And, you know, there are platforms
3 that exist which accommodate this. And that ties in, I
4 think, very cleanly with our request to be able to use
5 platforms or brokers providing an administrative as opposed
6 to a brokerage service by letting us book the trade on their
7 platform to, you know, expand the custodial expense
8 exemption in 17a-7 to specifically include that type of
9 service, where the security trade is noted in a public or a
10 publicly available record, that the trade is cleared through
11 the automated mechanisms of the dealer, and that there is an
12 ability to document that an appropriate pricing source has
13 been used to value the trade.
14 And that's, you know, also consistent with the
15 European prohibition against going out and getting quotes to
16 facilitate a trade elsewhere.
17 MR. McVEY: Thanks for that. And Kevin, maybe you
18 can follow on that with any experiences you've had on
19 crossing and also some context on how significant the
20 opportunity could be for an asset manager like Voya?
21 MR. GLEASON: Sure. So currently, we cross
22 roughly 3 percent of our trades. And I do that based upon,
23 you know, the 15,000 CUSIPs that we own across our 150
24 different funds. Last year in 2018, we crossed roughly 500
25 securities in excess. There were less than 100 of those



1 which were equity securities. We crossed bank loans, high
2 yield, securitized and other corporate issues. I think
3 we've all heard people talk about the challenges with
4 pricing those kinds of securities.
5 We actually saw an uptick in the third quarter and
6 the fourth quarter. So when people were stepping back from
7 the market and there was greater volatility, the difficulty
8 of finding partners, even though maybe some of our funds
9 within our complex were having redemption or other issues,
10 the investors believed in those securities and we were
11 receiving inflows in other securities or reallocating to
12 those particular asset classes, those security types.
13 And so I think we would see that increase from
14 that 3 percent. I don't have a good sense. We weren't able
15 to conduct all of the cross-trades we would have wanted to.
16 We don't sort of track sort of the misses, I guess, Rick.
17 But that's 3 percent of our fund platform.
18 I think the issues we see as around sort of that
19 control environment and making sure that we're really
20 educating our investors about what accounts, what securities
21 are eligible, about the documentation process, about the
22 approval process, making sure we have really robust policies
23 and procedures in place, making sure then we're doing
24 effective reporting to those internal governance committees
25 as well as to the board on those kinds of transactions. And



1 then, from a testing standpoint, are we looking at sort of
2 the right data, the right factors to make sure we're
3 capturing everything? If people are making mistakes, we're
4 identifying them for them and correcting it. Or if they're
5 committing actual fraud, that we're, you know, catching it
6 and taking appropriate disciplinary action.
7 So, you know, one of those things we do is we look
8 at same security, same broker trades over a one, a three, a
9 five, a seven-day period. We found, you know, most of our
10 advisers do that, and make sure we're not simply handling
11 sort of prearranged trades in that way.
12 MR. McVEY: Nora, maybe I can switch back to you.
13 But you work with many asset managers. And this seems to be
14 coming up more frequently, based on our conversations. But
15 if you could kind of summarize the three or four areas where
16 you see clients looking for change in the current 17a-7
17 rules? What would that look like in terms of a
18 recommendation that we could consider?
19 MS. JORDAN: Sure. The first issue is the
20 question of the fee. Can there be a fee charged? And
21 again, when you don't have registered investment companies,
22 you have to get best execution. And when you look at best
23 execution, you look at the whole picture. You look at the
24 price and you look at any cost of execution. And that's all
25 wrapped up together. And when you look back and your CCO



1 looks to see whether you got best execution, the price is
2 looked at to see whether it was fair. And, of course, some
3 trades, there are small commissions and some there are big.
4 So I think we'd really think it's time to get rid
5 of the part that says no fee that's not a customary transfer
6 fee. Or, at a minimum, it should be defined to include, you
7 know, cost of electronic trading networks. And it should be
8 defined to include custodian fees for actually transferring
9 something from one account to another. There's just too
10 much uncertainty. And, you know, advisers can be very
11 conservative and say, I don't want to deal with this. I
12 know the client is probably going to be better off but I
13 don't want the SEC coming in here and saying this wasn't a
14 customary fee.
15 So I think that's probably the first thing, is to
16 get rid of that and treat it the same way institutional
17 clients are treated and just look at best execution. That's
18 probably -- it's almost a little point but it does prevent a
19 lot of clients from doing trades.
20 MR. GLEASON: I think Nora raises a good point. I
21 think there are some firms we know of at Voya, some of our
22 subadvisers, who just back away from doing cross-trades
23 because of just the concern that, in hindsight, the
24 regulators may view that transaction. Or they may just make
25 a mistake and that all the conditions they have to meet in

1 order to make sure it's compliant, they'd rather just go out
2 to the marketplace instead.
3 MR. WALLIN: Right. And I'd add to that that the
4 operational risk that's incurred by doing it as a
5 nonstandard process outside of our electronic trading is
6 something that not only limits our opportunity set but makes
7 it very uneconomical to do it for smaller trades, where
8 there could be significant benefits, particularly to retail
9 clients.
10 MS. JORDAN: And then, of course, the second issue
11 is that we really think that it should not define so
12 precisely in the rule the manner in which you achieve best
13 execution. For example, you shouldn't have to get three
14 bids and three offers and use the average or the mid. All
15 of those interpretations, I think, are outdated in light of,
16 you know, the current market for fixed income securities.
17 And instead, it should be a more general approach,
18 consistent again with what happens with institutional
19 clients, and it's just best execution. The adviser has a
20 fiduciary duty to make sure the trade is in the best
21 interest of both clients.
22 And so again, for example, an independent pricing
23 service might be the best way to go. Or the best way to go
24 might be to go to an electronic trading network. And I know
25 the SEC has talked a lot about electronic trading networks



1 and the benefits you can get from them. And yet it doesn't
2 seem to be allowed in the rule.
3 So we would propose that there just be a general
4 obligation to get best execution. And those are really the
5 two big things.
6 Encompassed in that is, you know, it's product
7 agnostic. Meaning, right now, the interpretations apply to
8 municipal securities, unclear whether it applies outside of
9 that. But those two issues really would fix the rest of it,
10 I think.
11 MR. WALLIN: Yeah, and the requirement that you
12 just get best execution and not have any prescribed point of
13 execution would be important for the trades where you have
14 asymmetry, like the bid back, but you don't have the same
15 level of benefit -- each client benefits but one client may
16 benefit more than the other because of the other people that
17 were in that trade that were not affiliated.
18 MR. McVEY: And just to expand on that a little
19 bit, the one place where we and others have been able to
20 provide competitive solutions is in municipal bonds for SMA
21 accounts, where auctions are basically run and through alt
22 all networks, the asset manager can initiate an inquiry and
23 also at the same time competitively bid with everyone else
24 to buy the security back. And the way the rules work is, as
25 long as there are two other competing bids alongside their



1 own and they are the best price, then they can maintain that
2 trade internally. So that has gained some support around
3 the municipal industry but is obviously very limited in
4 terms of the kind of crosses that all of you can conduct
5 today.
6 MS. JORDAN: And I would also add, there are a lot
7 of protections that could be put in place in the rule, if
8 people feel that investment management companies need more
9 protection than, say, an institutional client. Because you
10 do have a board of directors there and the board could
11 approve, say, the electronic trading network after hearing a
12 description of how it works and what safeguards are in
13 place. It could approve the pricing service. It could
14 require reporting. The board or the rule could require
15 reporting to the board on a periodic basis. There are all
16 kinds of safeguards that could be in place, you know, sort
17 of before and after that might make people feel more
18 comfortable.
19 MR. WALLIN: Yeah. To sum it up, the ability to
20 cross for most of our clients outside the registered
21 investment company universe is already sufficiently flexible
22 to allow us to do what we want and with perhaps the
23 asymmetrical execution being the one issue that would have
24 to be addressed with the Commission. The problem is that
25 '40 Act companies are such a huge part of the landscape that



1 you can't effectively cross and have a standard crossing
2 mechanism that doesn't incorporate them. And right now, the
3 standards that are in place are, you know, I wouldn't say
4 they're too high, I would say they're out of sync with the
5 market as it is now, 50 years from its first adoption.
6 MR. McVEY: Great. Maybe time to open it up to
7 questions from others on the committee.
8 MR. HEANEY: Yes, please. Larry.
9 MR. HARRIS: A couple quick comments and then a
10 question. First of all, I note with a certain amount of
11 amusement that if we had a consolidated NBB, all of this
12 would be an easier problem. So that's an argument for that,
13 but that's a different issue.
14 I'd also note that, were people completely honest,
15 we wouldn't have an issue with this issue. I mean, we have
16 this problem because historically there have been problems
17 with crosses. And I would like to note that the problem is
18 actually twofold. One is getting the right price for the
19 cross, which is a trading issue. But the second problem has
20 to do with the allocation of information.
21 If an investment manager becomes aware that a
22 security is overvalued and they have one account that they'd
23 like to favor over the other, they can take that position
24 from the account that's the favorite account and put it into
25 another account and then the information comes out and

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1 there's been a transfer of wealth that's inappropriate. And
2 that's a serious problem and we're not going to address that
3 problem by talking about how to find the right price because
4 there's an information asymmetry there. That's an argument
5 for making this whole process difficult to begin with. But
6 there are solutions to this.
7 So if indeed the question is do we want to protect
8 against a fraud, we just have to figure out what are the
9 circumstances where we wouldn't expect fraud. If we
10 wouldn't expect fraud, then we should surely be very
11 permissive. So one case where we wouldn't expect fraud is
12 if, instead of the transfer of a single security, we're
13 talking about the transfer of a portfolio. So one fund is
14 getting smaller, another fund is getting bigger. Why not
15 just transfer a pro rata share of the entire portfolio from
16 one to the other? If that works, then that would solve the
17 problem. There's almost no question of -- there's no fraud
18 there.
19 Another situation is if you have one entity that
20 has two separate submanagers who are not subject to the
21 discretion of the adviser. So you have two subadvisers,
22 each making independent decisions, then the fact that it's
23 going through the central adviser, if the central adviser
24 doesn't have any discretion over the two subadvisers, then
25 surely there are adequate protections because each of the

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1 subadvisers has their self-interest. And so in that
2 circumstance, I think we should be pretty permissive.
3 So the question is, the easiest way to solve this
4 problem is to say, look, if -- I mean, what's actually going
5 on here? Why are we talking about transferring just a
6 single position instead of a portfolio? As the markets have
7 advanced and electronic trading is easier, I mean even the
8 last session we just talked about is -- or the second to
9 last session, we talked about portfolio trading. If we were
10 just talking about portfolio trading, this would be an easy
11 issue.
12 So if this is difficult with respect to a single
13 security, can we make it easy for transferring a pro rata
14 share of a portfolio and be done with the problem?
15 MR. WALLIN: I think the answer to that is that
16 it's impractical and uneconomical in the fixed income
17 context to do that. You know, the circumstances that
18 trigger -- and, you know, your point about fraud is a very
19 good one and we address it, and I think my colleagues here
20 all address it by looking very carefully at what the impetus
21 of the trade is. If we would have fund one with a cash
22 rollout and fund two looking for extra exposure, if that
23 were as simple as our investment environment were, it still
24 wouldn't be a solution in my view because, you know, we hold
25 hundreds and hundreds of positions in an account. Our

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1 position size is generally 10, 15, 20 basis points. You
2 know, we don't hold 3 percent positions like an equity
3 holder does. So if you just take the ticket charges, the
4 problems associated with minimum position size, et cetera,
5 et cetera, it's not worth doing.
6 We identify specific positions to sell out of a
7 fund so we're not left with underweighted positions, we're
8 not left with, you know, odd lots except in certain
9 circumstances. And, you know, we may prioritize the
10 disposal of a security from a fund that's experiencing an
11 outflow but still value that security. And, you know, the
12 combination of the objective outflow being observed plus the
13 ability to reference well-constructed matrix pricing in the
14 market, I think, addresses your concern.
15 You know, we're not looking to make this 10 or 20
16 percent of our portfolio trading. You know, Kevin mentioned
17 3 percent. That would be a lot to us. I don't think that's
18 an outrageous number. But that's what we're talking about,
19 doing things at the margin.
20 And when you talk about doing it in other
21 contexts, one of the contexts where this can be very
22 valuable is in the retail separate managed accounts,
23 particularly in the muni area where, again, we don't
24 necessarily have the same problem because we already have
25 the SEC no-action letters. But if you look at issue size,

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1 if you look at all of the factors relating -- you know, that
2 impede upon the liquidity of muni securities, the ability to
3 move securities from an account that needs -- that's raising
4 cash into accounts that are short duration or have too much
5 cash is very quantifiable. And the risks that you're
6 alluding to are pretty much -- you know, it's pretty much
7 obvious that they don't exist, absent abject fraud.
8 There's a lot of practical aspects to managing
9 fixed income securities that people don't properly
10 appreciate when they're trying to compare them to trading in
11 equity securities. The magnitude of the transaction cost
12 compared to the return on the security, the fragmentation of
13 the market, the different position, the portfolio
14 construction techniques.
15 You know, I recognize the merits of your proposal
16 from an antifraud standpoint, but I don't think they would
17 be practical at all to implement in a fixed income context.
18 Nor do I think they are necessary to prevent against fraud.
19 I think outlining very clearly what should be the impetus
20 for a trade is the first step in doing that.
21 MR. DIAL: I'll just respond if I could that, a
22 direct answer to the question on why not trade in portfolios
23 is because we don't trade in portfolios; we trade in
24 individual CUSIPs. We research CUSIPs, we research issuers,
25 we purchase issuers, we sell issuers. And when our clients

1 come to us asking for redemptions, we look at their
2 portfolio and determine which securities to sell.
3 And if we were required to sell baskets of
4 securities, there's not a ready buyer for a basket of
5 securities. So that would actually create a further
6 impediment to crossing.
7 But you did hit on the key point, which is there
8 is this avenue for fraud through cross-trading, where you
9 could park securities that are -- in certain accounts or
10 dump securities on your less favored accounts. And so you
11 do need to figure out a way to do that. The current 17a-7
12 doesn't. The current 17a-7 speaks to that by, I guess,
13 arguably making it more difficult to do these crosses. But
14 it doesn't directly address the potential for fraud.
15 So one possible avenue for an investor protection
16 route when looking at this is to borrow a page from what the
17 SEC has recently been doing in certain of their risk
18 management releases, like in the liquidity risk management
19 release and the derivatives proposal where they require risk
20 management programs.
21 You could envision a rule or requirement that says
22 you can cross, you can cross at a best price, you can cross
23 in an easy way, you can cross looking at best execution, so
24 long as you have a program to evaluate those trades, to
25 disclose those trades to boards and to forensically identify



1 any trades that may have been violative of the spirit of the
2 rule, that may have not been for correct reasons.
3 For example, if you looked at a series of trades
4 and saw a roundtrip, three roundtrips for the same fund.
5 That's going to look a lot like that they were holding that
6 trade there -- that security there in that fund for perhaps
7 the wrong reasons or making that fund buy the security for
8 the wrong reasons.
9 So I think having a rule and having a review of
10 this to look at directly that fraud issue as opposed to just
11 generically making it more difficult is well worth it,
12 especially considering the potential investor savings.
13 MR. HARRIS: I want to respond very quickly and
14 very, very quickly. I would like us to be as lax as
15 possible where we can be. I just want to respond to one
16 small thing you said.
17 If indeed you're doing a lot of research to value
18 securities, to decide what one portfolio should be selling,
19 then why should the other portfolio be buying it? So
20 there's an inconsistency. It has to be researched for
21 something other than value.
22 MR. DIAL: The archetype situation for this is
23 where one client is selling because they want their money
24 back. So we have a pension plan that's paying out benefits.
25 We may have a mutual fund that has had outflows. These



1 funds are requiring us to raise cash.
2 We love the securities they're holding, we're very
3 positive on them. In fact, we want to keep them in house.
4 So we want to sell them to our other client accounts because
5 we've spent a lot of research on understanding those
6 issuers. And a lot of times now, we can't cross them. And
7 so we lose the value of that research and we have to go look
8 at names and purchase names for other accounts that we may
9 not like as much.
10 MR. HARRIS: So that's a situation that fits
11 exactly into the paradigm I described, which is just do a
12 portfolio trade. And if it's too many names, then have a
13 procedure where you pick them, you know, every other name by
14 alphabetical order or something like that.
15 MR. WALLIN: Well, but there's two points. You
16 know, again, the more you split the trades, the more
17 fragmented it is, your ticket charges don't go down and
18 there comes a point very quickly --
19 MR. HARRIS: I'm confused, I'm sorry. We're
20 talking about trying to avoid ticket charges by doing these
21 crosses. Are you talking about --
22 MR. WALLIN: You don't avoid them by doing the --
23 MR. HARRIS: Are you talking about the custodial
24 tickets?
25 MR. WALLIN: Yeah. Yeah. And they can become



1 significant when you're doing small trades.
2 MS. JORDAN: But aren't you assuming the two funds
3 are exactly the same?
4 MR. WALLIN: Right. That's the point I was --
5 MS. JORDAN: You wouldn't want to sell every
6 single security from A into B unless it had exactly the same
7 portfolio.
8 MR. HARRIS: Again, we should end this because
9 we're getting late and I don't want to spend too much time.
10 But I just observed --
11 MR. HEANEY: I agree with that. Let's just stop
12 the chain of thought for just a second. I appreciate you
13 guys' attempts to answer as well.
14 I want to turn to Kumar before we wrap up.
15 MR. VENKATARAMAN: Thanks, Michael. I'll be
16 brief.
17 So I understand the economics driving the need to
18 cross and the benefits to the buyer and the seller. But in
19 many markets, the security is not actively traded. So you
20 had pointed out the possibility of using an independent
21 pricing service and I see the merits of that as well.
22 But at the same time, I worry a little bit about
23 whether in the case of securities which are not actively
24 traded, whether the price would be fair and whether it would
25 actually reflect the price that either party independently

1 would obtain if they approached the market and tried to
2 obtain either executable bid and offers or actually
3 participate in a transaction and actually execute that
4 trade? Do you have any thoughts on that?
5 MR. WALLIN: Yeah. It's, again, a difference
6 between equity and fixed income. Equity, there is a
7 constant stream of liquidity for most issues. It's very
8 unfragmented. And there's not, you know, a great argument
9 for relying on derived prices. Fixed income securities, as
10 we all know, 20 percent trade frequently, which means they
11 trade once a week. The others trade very infrequently.
12 And yet, for the most part, you know, they have
13 intrinsic value. You know, we have an aggregation tool, for
14 example, that's premised on the concept that you can compare
15 characteristics across different fixed income issues and
16 come up with various metrics for exposure. And, you know,
17 there's a difference between a bond that doesn't trade
18 frequently and a bond that's distressed. And that's what
19 our research is designed to distinguish between.
20 So the situation we'd be looking at is a security
21 that may not be traded often, that may take a big hit when
22 we sell it and then take a big hit on the other side when we
23 try to buy it back, if we're able at all to buy it back, but
24 we have confidence both from the standpoint of a pricing
25 service and understanding of how the pricing service works,



1 and our own independent research which has vetted that
2 security thoroughly, that that exposure is good an
3 department we should retain it in house.
4 As opposed to, you know, one of the points I want
5 to go back to Mr. Harris's question. But out of 20
6 securities that we may sell in a portfolio prompted by a
7 redemption, 19 of them may be easy to sell and get back at a
8 very economical cost and we don't want to go through the
9 crossing process.
10 So, you know, it's a combination of the fact that
11 the security may not trade a lot, it has desirable
12 characteristics, it's reasonably priced by a pricing service
13 and it's vetted by our research.
14 MR. GLEASON: And I'd like to think that maybe the
15 pricing service will also take out some of the bad, you
16 know, bad actor behavior. So you've now removed some of the
17 sell side/buy side dynamic, you've interposed an independent
18 third party who has determined that price. Your traders
19 aren't going out to folks that cover them on a daily basis
20 who they interact with and sort of leaning on them for
21 prices in order to come up with, you know, broker quotes
22 that, you know, will they truly stand behind? Are they
23 indicative or are they actionable quotes?
24 And so I would like to think, you know,
25 interposing that pricing service maybe eliminates some of



1 those pressures and will actually result in a better price
2 at which to cross those trades at.
3 MS. JORDAN: Yes, and in the institutional market,
4 they might not do the trade if they weren't comfortable with
5 the price. Or they might not be able to get a pricing
6 service to price it. And sometimes, if it's a very illiquid
7 security, it costs a lot to get it priced and they don't
8 want to spend the money.
9 So there are some practical things that come into
10 play in practice on the institutional market when that
11 happens. So I would suspect, if it's really an illiquid
12 security, it's just not going to be crossed because the
13 adviser won't want to take the risk.
14 MR. WALLIN: Yeah, I mean, I would second that.
15 We're not looking to cross illiquid or distressed
16 securities; we're looking to cross securities where there is
17 a clearly stated, derived price, the same price that we
18 would use to value that security for the purposes of
19 redemption, where we have conviction backed by evidence that
20 that security is worth something, and where we can
21 demonstrate that similar exposure trades at a similar price
22 to what we're crossing at.
23 MR. HEANEY: Final question, Sonali.
24 MS. THEISEN: It's more going to be a bit of a
25 comment, just relating this back to our earlier panel that



1 we had around tagging of portfolio trades on TRACE and just
2 a comment around, again, this increased dependence in the
3 marketplace on composite pricing, I think, is a very
4 important one, very important trend to follow.
5 I do think that there would have to be, if we
6 consider a recommendation, again, some sort of understanding
7 of what we mean by when we say a bond becomes illiquid.
8 Because again, I do worry bout those edge case -- not
9 because the pricing services are doing anything incorrect.
10 But just the illiquid tail, tail where there may be a
11 composite price. I agree with what James said, it would
12 probably be better if that bond was being crossed for both
13 sides than selling it out and crossing bid/offer. At the
14 same time, we have to account for the fact that we don't
15 want to have an echo chamber on really, really illiquid
16 instruments that get, you know, crossed at prices where the
17 composites are putting something out, but we don't have a
18 high degree of confidence.
19 MR. WALLIN: I mean, the fact is that the
20 transaction costs in the fixed income market are higher than
21 in the equity market. And this is a -- one of the methods
22 that we have to mitigate that for our clients in what we
23 perceive to be extreme situations.
24 MR. HEANEY: I want to take this opportunity to
25 thank the panel for coming down and sharing your thoughts.

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1 It may seem like a simple issue but maybe it doesn't have a
2 simple solution. But nonetheless, it seems fairly outdated;
3 25 or 50 years have gone by since we have been able to
4 address this, given all that's changed. So we appreciate
5 your thoughts and comments. And Rick, thank you for
6 assembling the panel and moderating. I am sure we will hear
7 about it in April.
8 I just want to thank everybody, first for your
9 patience for running over 35 minutes, but most importantly
10 for participation. This is another productive meeting. I
11 continue to be so impressed by everybody's dedication and
12 energy to these topics. So thank you very much.
13 Our next FIMSAC meeting is scheduled for April 27.
14 So we are coming to the end. Six months remaining. Two
15 public meetings. But plenty of time for a lot of
16 subcommittees between now and then. So I look forward to
17 them.
18 At this point, I'll entertain a motion to adjourn.
19 All in favor?
20 Thank you, and safe travels.
21 (Whereupon, at 3:36 p.m., the meeting was
22 adjourned.)
23 * * * * *
24
25

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1 PROOFREADER'S CERTIFICATE
2
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4 COMMITTEE
5 File Number: OS-0210
6 Date: Monday, February 10, 2020
7 Location: Washington, D.C.
8
9 This is to certify that I, Christine Boyce
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11 transcript is a complete, true and accurate transcription of
12 all matters contained on the recorded proceedings of the
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