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SEC Examining Hidden Prices in Bond Trading.

The practice of dealers' showing clients different prices for the same securities on electronic bond-trading platforms is drawing the scrutiny of the [Securities and Exchange Commission](#), which is concerned that smaller investors are being penalized.

SEC regulators want to understand why brokers sometimes block their rivals and clients from seeing some of their prices for municipal, corporate and other bonds, according to a person with direct knowledge of the inquiry. They're examining whether being able to turn quotes on and off allows market manipulation, and whether smaller buyers are given worse prices, the person said.

The probe underscores the growing concern that the infrastructure of the U.S. bond market hasn't kept pace with a 23 percent expansion in the past six years, with much of the trading still conducted through telephone conversations and e-mails. The SEC separately is looking into the way the biggest banks allocate corporate-bond offerings and whether they give preferential treatment to certain clients.

"There's a club-within-a-club sort of atmosphere people started to get very concerned about," said Robert Smith, chief investment officer at Sage Advisory Services Ltd., which oversees about \$10.5 billion. "In essence, you could start to see two different prices for the same security."

The inquiry into alternative trading systems has focused on those that cater to individual investors as well as dealers trading among themselves, according to the person, who asked not to be identified because the examination isn't public.

INCREASED TRADING

The probe is an attempt to get more information, rather than build a case for an enforcement action, and is being conducted by the Office of Compliance Inspections and Examinations wing of the SEC, according to the person familiar with the matter.

Even if alternative trading systems "don't account for a majority of the trading, they can be a source of information, and there's the potential for filters to be used in a manner that would distort the market," said Kevin Goodman, national associate director of the broker-dealer examination program at the division.

U.S. investment firms predict that 30% of corporate-bond trading will occur electronically by 2015, up from 14 percent of investment-grade notes in 2012, according to an August 2013 report by Greenwich Associates and McKinsey & Co. As much as 50% of municipal trades already may occur electronically, according to a comment letter to the SEC last year from trade-system operator TMC Bonds.

PROMOTING TRANSPARENCY

“We want to understand how we can promote more transparency” and how electronic trading is “either contributing or not contributing to transparency,” said Mr. Goodman, who declined to confirm the existence of any examinations.

The SEC has contacted providers including Tradeweb Markets and TMC Bonds, seeking information about the systems they manage that allow dealers to buy and sell debt to one another and to investors, according to two people with direct knowledge of the matter who asked not to be identified because the conversations were private.

Bloomberg, the parent of Bloomberg News, competes with Tradeweb in some businesses, including bond trading with institutional investors. Bloomberg’s trading platforms aren’t geared toward individual clients.

There are reasons some electronic systems enable bond dealers to block rivals from seeing their price quotes, such as if they have found a firm consistently fails to stand by its offers or provides off-market values, said Thomas Vales, chief executive officer of TMC Bonds, who confirmed he’d discussed the issue with the SEC.

Clayton McGratty, a Tradeweb spokesman, declined to comment.

Banks have increasingly turned to electronic systems to sell bonds on behalf of their clients as a way of aggregating a greater number of bids. That’s become more appealing as it’s become more expensive for dealers to use their own money to make markets because of higher regulatory capital requirements.

“There’s a lot of interest in the market given the way it’s grown,” the SEC’s Mr. Goodman said.

NEW ISSUES

Rules issued in 2010 by the Basel Committee on Banking Supervision and the Dodd-Frank Act passed by Congress prompted Wall Street dealers to cut their inventories of corporate securities by 76% from the 2007 peak through last March, when the [Federal Reserve](#) changed the way it reported the data.

At the same time, the size of the U.S. bond market has swelled to \$39.9 trillion from \$33.6 trillion in 2008 as the Fed held borrowing costs near zero and bought trillions of dollars of Treasuries and mortgage debt, according to data from the [Securities Industry and Financial Markets Association](#).

While the amount of debt outstanding has soared, trading volumes have failed to keep pace, prompting investors to hold onto notes rather than trade more actively and risk not being able to get the securities back. The scarcity of available bonds has led to increased demand from buyers for a slice of new corporate issues.

Regulators have been seeking more information about how the biggest banks decide to distribute the new bonds. The Goldman Sachs Group Inc.’s annual filing last month added “allocations of and trading in fixed-income securities” to a list of activities at the firm that are subject to open regulatory scrutiny.

One of the SEC’s priorities this year is to evaluate “factors that may impact the quality of execution in the fixed-income market,” including market structure and the use of alternative trading systems, it said in a January statement.

“In the wake of the credit crisis, investors have obviously had a greater focus on fixed income,” said

Will Rhode, director of fixed-income research at Tabb Group. “There’s a question of how retail investors access this market.”

Bloomberg News

Mar 21, 2014 @ 12:02 pm (Updated 1:32 pm) EST

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