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Gallagher: Encourage Electronic Platforms, Avoid Liquidity Cliff.

WASHINGTON – The Securities and Exchange Commission needs to remove regulatory impediments to the development of electronic trading platforms for the fixed income market and work to avoid a looming "liquidity cliff," Commissioner Daniel Gallagher said Friday.

Gallagher spoke extensively about the muni and corporate fixed income markets in a speech at the 47th Annual Securities Regulation Seminar of the Los Angeles County Bar Association. The Republican commissioner has been an outspoken proponent of municipal market transparency and a prominent critic of the priorities set for the SEC by the Dodd-Frank Act. He and fellow Republican commissioner Michael Piwowar have each spoken about a need to improve transparency for retail investors, including requiring dealers to disclose markups in riskless principal transactions.

"Topping the list of issues in need of our immediate attention are the fixed income markets," Gallagher said, noting the extremely high 75% retail participation in the muni market. "It should be a wakeup call to us all that such a staggering percentage of our fixed income markets rests in the hands of ordinary investors who often do not understand the product they hold or the accompanying risks, including the devastating effect an inevitable interest rate hike could have on their investment."

Gallagher sounded his support for the development of electronic trading platforms, a recommendation from the commission's 2012 comprehensive muni market report, and joined Piwowar in publicly voicing skepticism about the complexity of bond deals. Gallagher said the SEC should work to reduce the number of "bespoke" bond offerings in favor of more standardized offerings because the complex securities are unlikely to trade frequently. Piwowar spoke on that topic earlier this year, and said that his research as an economist has led him to believe that simplified bond offerings that do not include features like sinking funds, special redemption provisions, and credit enhancements would benefit issuers and investors alike.

Gallagher said he is concerned about "the clear and present danger" of a liquidity cliff in the debt markets.

"Over the past few years, these markets have witnessed historic growth due to a zero percent interest rate environment," Gallagher said. "While investors have been flocking to bonds at a record pace, dealer inventories have shrunk by nearly 75% since 2008 as financial institutions have been forced to deleverage in the wake of Basel III, the Volcker Rule, and other constraints introduced by prudential regulators ostensibly in response to the crisis. This has set the stage for a potentially dire liquidity crisis. When interest rates rise — which the Fed has indicated could happen as early as next summer— outflows from high yielding and less liquid debt could drive bond prices down. Which raises the question of the hour — where is the necessary liquidity going to come from?"

But Gallagher said the SEC needs to work with the bond industry to create more liquidity and not try to impose an unworkable regulatory system, he warned.

“The SEC needs to take steps to facilitate bond market liquidity, ideally by working with the industry and investors to create workable, market-based solutions,” he said. “The last thing we need is a Dodd-Frank Title VII-like regime in which an equity market structure is overlaid on a market that operates in a fundamentally different manner.”

Gallagher added that the commission needs to finish removing references to credit ratings from its rules, something it took a step toward when it proposed last week to remove those references to credit from its Rule 2a-7 governing money market funds. Above all, the SEC needs to do a big picture reevaluation of the course it is on, he said.

“But beyond these discrete items, we must take a step back and realize where we are today as a regulator and where we have been for the past five years,” he said. “We need to set a course to once again [be] a preeminent federal agency and thought leader in the policy debates that have been for too long happening around us.”

THE BOND BUYER

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OCT 27, 2014 2:42pm ET