SEC Fixed Income Market Structure Advisory Committee (FIMSAC) Meeting.

SEC Fixed Income Market Structure Advisory Committee Meeting

Discussion Panels

- Draft Recommendation for Investor Education Regarding Retail Notes
- Draft Recommendation on Certain Principal Transactions with Advisory Clients
- Updates from the Technology and Electronic Trading Subcommittee and ETFs and Bond Funds Subcommittee
- Content and Timeliness of Municipal Issuer Disclosures
- Credit Ratings: Future Modifications or Status Quo

Opening Statements

In his opening statement, Securities and Exchange Commission (SEC) Chairman Jay Clayton highlighted some of the developments from past Fixed Income Market Structure Advisory Committee (FIMSAC) recommendations and the importance of the recommendation to increase education for retail investors. SEC Commissioner Allison Lee also highlighted the importance of clear disclosure. Division of Trading and Markets Director Brett Redfearn discussed the distinct challenges of the Fixed Income market and thanked the FIMSAC members for their efforts.

Draft Recommendation for Investor Education Regarding Retail Notes

- Susan Sheffield, GM Financial
- Sarah Tucker, Raymond James
- Brian Walker, Incapital
- Brad Winges, Hilltop Securities
- Moderator: Mihir Worah, PIMCO

Winges described the retail note market compared to the other areas of corporate bonds (institutional and intermarket). He said that in contrast to institutional advisors who need liquidity, most retail investors tend to buy and hold and are willing to forgo some liquidity for higher yield. Worah added that as long as investors are aware of the liquidity trade-off, it should be their choice.

Sheffield and Scott Krohn described how retail investors purchase these securities and how retail bonds are used in their company's capital structure. Sheffield stated that GM Financial issued approximately $558 million over last two years with a two- to ten-year maturity. Krohn stated that Verizon has about $1 billion retail bonds outstanding which represents about one percent of its total bond issuance. Sheffield and Krohn explained that retail bonds allow investors to buy these bonds at par on the primary market and could be compared as an alternative to a CD. While these bonds have a call option Sheffiled and Krohn stated their companies have not exercised it to date. Tucker stated that during the last down cycle of interest rates, some issuers exercised the call option but most investors understood this feature.

Walker described the process of issuing the retail bonds, and emphasized that this is the first time retail investors can participate in new issuances of individual companies rather than a collective of secondary bonds in ETFs or bond funds. Walker stated investors make their decision to invest over one week and have the note come due at par. He continued that the corporates distribute to the investors through numerous brokers and dealers but will only have to settle one note.

Tucker said that investors typically purchase these retail notes when they want an individual bond with stated predictable income and maturity, and these investors typically have a specific time in mind when they want the money back to pay for something, such as college tuition. Tucker said she does not see a high volume of trading, especially compared to the institutional market, but that this is not surprising since these notes are most appropriate for buy and hold retail investments. She said that investors are able to build in liquidity over time by laddering the bonds to come to maturity over several years. Tucker stated that while the brokerage transaction cost may initially appear high for investors, she highlighted that there is only an initial brokerage cost and the cost of ownership over time is less because investors are holding to maturity.

Question & Answer

Clayton stated that he wants to ensure advisors understand these retail notes and that investors especially understand the differences in costs compared to institutional notes. Walker stated that investors can compare the cost of retail notes to institutional notes on the Trade Reporting and Compliance Engine (TRACE) but there is no single page comparison. Tucker stated that her firm provides tools for advisors to provide a comparison to show trade-offs. However, Tucker stated that the investors focus on yield and maturity. Walker said that his firm creates their own marketing materials that reiterate the same risks described in the notes' prospectuses that dealers can use to ensure customers are aware of the risks.

Gilbert Garcia of Carcia Hamilton & Associates asked what the typical yield or coupon differential is, whether investors know about TRACE and whether these bonds are traded on the same or different books. Walker stated there is typically a 20-25 basis point coupon differential. Tucker noted that fees in a commission account will be about the same for the primary and secondary market, and that investors know of TRACE and her firm gives links to TRACE and bond facts website on trade confirmations. Tucker added that traders do both institutional and retail and can evaluate both markets.

Larry Harris asked what happens to the survivor option upon secondary transfer and with the note being conditioned on a life, whether life insurance regulators have focused on these. Walker and Tucker stated the survivor option passes with the bond and will be based on the purchaser's life span. Additionally, Tucker explained that insurance companies issue these notes and they go through their analysis.

Horrace Carter asked whether this is different from the inter-note program and whether those issues have been addressed. Winges stated this is not just an inter-note program and with technology developments there are more electronic trading platforms where issuers can issue securities in any structure an investor wants. Winges further said this other market is continuing to grow with the ability to create bespoke bonds, which may have different education needs.

Rich McVey asked the panelists about any downside to the recommendation to enhance education. Tucker stated that there is no downside to education but it needs to be properly framed. Walker stated that any efforts need to be balanced and not overly onerous so they do not restrict their use.

Redfearn referenced Regulation Best Interest and asked how dual-registrants decide whether they

are acting as a broker or advisor. Tucker explained that with a buy and hold investment there is not as much necessary advice, so they may elect to act on a brokerage or commission-based agreement but brokers will continue monitoring the notes. Tucker added that most retail investors can choose their appropriate advice model by purchasing at par with an upfront transaction cost or purchasing less than par with concession done on an agency basis.

The recommendation was unanimously approved.

Draft Recommendation on Certain Principal Transactions with Advisory Clients

- Jude Arena, Bank of America Merrill Lynch
- John Bagley, MSRB
- John Cahalane, Tradeweb
- Chris Ferreri, Hartfield, Titus, and Donnelly
- Craig Noble, Wells Fargo Advisors
- Moderator: Lynn Martin, ICE Data Services

As to whether and how this preliminary recommendation on blind bidding would benefit retail investors, Arena stated that allowing advisor clients to access those bids is a positive but having a different market structure and blind bidding creates unnecessary confusion. Noble stated that this will help with liquidity and that the subcommittee should look to the individual Rule 206 exemption for client advised accounts as to how it helped clients.

The panelists then discussed what needs to be built to implement a blind bidding protocol. Cahalane stated this would require minimal additional work as the platform already has functionality, noting that some customers could bid in the blind but those connecting through API may need additional technology changes. Ferreri stated that the work is straightforward for those parts of the workflow but may be more difficult for those not already in the system. Arena added that most smaller broker-dealers would have to rely on alternative trading systems (ATSs) but larger dealers would decide whether to create their own process or rely on ATSs.

Noble expressed concern that the recommendation only focuses on municipal securities which requires additional coding for all managed accounts. Bagley said he views the recommendation as a positive for providing liquidity but expressed concern that this will make managed accounts even more profitable.

Martin asked whether improvements to best execution would obviate the need to bifurcate the process. Jude stated that a better way forward would be to rely on the best execution and fair and reasonable requirements and have an explicit prohibition on pennying. Bagley said that it would be better to address this problem now rather than wait for an express prohibition on pennying.

Question & Answer

Carter said he thought it would be superior to have one process, but asked whether it is possible to have two. Cahalane replied that it is still possible to have two processes as some clients already bid in the blind, adding that it should be one way or the other but Tradeweb can handle both processes.

Sonali Thiesen asked whether a prohibition on pennying and unsetting 206 would be a better solution from a cost-benefit perspective. Bagley replied that the concern is there is no guarantee or time frame on what will happen with pennying. Noble and Arena said that allowing a blanket waiver to 206 and a prohibition on pennying would allow advisory clients to get access to bids without major changes to market structure. Noble added that a more general exemption, rather than just the

individual exemption for client advised managed accounts, would be a fair process and would help.

The recommendation was approved in a 12-4 vote.

Updates from the Technology and Electronic Trading Subcommittee and ETFs and Bond Funds Subcommittee
Technology and Electronic Trading Subcommittee Update

Richard McVey discussed the two issues of focus for the subcommittee: (1) pennying; and (2) reviewing the comment on FINRA's new issue proposal. On the pennying recommendation, he said the subcommittee is working on adding the discussed language into the recommendation and clarifying the difference between pennying and legitimate last look. As for the FINRA new issue proposal, he explained the committee filed a letter to reiterate the need for this service and clarify its recommendations.

ETFs and Bond Funds Subcommittee Update

Ananth Madhavan stated that the subcommittee's recommendations are timely considering the recent European Systemic Risk Board (ESRB) report on this issue. Additionally, Madhavan discussed the two potential upcoming panels on: (1) the role of authorized participants and potential market structure improvements to deal with step away risk during times of stress; and (2) bond index construction funds which requires frequent predictable trading that leads to non-fundamental trading effects.

Content and Timeliness of Municipal Issuer Disclosures

- Tom Doe, Municipal Market Analytics
- Sheila May, GW&K Investment Management
- Tom McLoughlin, UBS
- Tim Schaefer, Office of the California State Treasurer
- Kendel Taylor, City of Alexandria
- James Wallin, Alliance Bernstein
- Rebecca Olsen, Office of Municipal Securities, SEC

Olsen gave an overview of the regulation of the municipal securities market, saying the municipal market does not have the same regulations as other securities largely due to the broad exemptions from the Securities Act of 1933 and Securities Exchange Act of 1934. In the absence of typical registration and reporting requirements for municipal securities, she said that investors are protected by: (1) enforcement of anti-fraud provision prohibiting deceit, misrepresentation and fraud; (2) registration and regulation of broker-dealers and municipal security dealers; (3) Rule 15c2-12, which provides a basic disclosure framework; (4) registration and regulation of municipal advisors; and (5) SEC guidance.

Schaefer described the information provided to rating agencies, saying that California is unique in that it typically raises $4-6 billion in each the spring and fall and it provides the rating agencies a draft of its Appendix A, which provides material investor information, and will amend Appendix A to reflect the rating agencies' questions before making it public. Taylor said Alexandria typically raises $23-100 million each year, and the disclosures focus on describing the changes from the previous year.

As to whether rating agencies receive additional useful information, Wallin expressed his belief that rating agencies have the advantage of receiving information on an ongoing basis while investors only

receive information when the issuer is in need. However, McLoughlin stated that the primary disclosures are typically sufficient but investors don't receive unaudited interim financial statements. May said that rating agencies receive additional information but most of that information may not be material. Doe added that issuers typically make themselves available to investors but face additional costs associated with providing that information.

Wallin, McLoughlin and May stated that financial reports lose their relevance the later they are published, and in those cases, firms must rely on independent sources and interim information. Wallin and McLoughlin explained their firms will first look for this information on EMMA and then look at the issuers' websites for this important information, but both sources are primarily useful only for institutional investors and vary in their usefulness. May said her firm goes to issuer websites first and then uses EMMA for new documents or event notices.

The panelists discussed whether disclosure practices affect issuers' cost of borrowing. Wallin said that there is anecdotal evidence that the lack of accurate and timely disclosures impacts issuers' borrowing ability, but there is no quantifiable evidence. McLoughlin and Doe stated that there is more demand than supply, so there is no penalty for not disclosing timely, accurate information. McLoughlin noted that smaller issuers don't always see the cause and effect between price and publishing financial information. However, both Taylor and Schaefer stated they believe their disclosure practices help their ability to issue bonds.

Credit Ratings Future Modifications or Status Quo

- Daniel Gates, Moody's Investors Service
- Yann Le Pallec, S&P Global
- Otis Otih, Mars
- Susan Sheffield, GM Financial
- Rachel Wilson, Iron Mountain

Gates stated that the analytical approach for credit rating agencies relies on quality and consistency. He said that investor demand is important for producing high-quality ratings, and added that it is essential for rating agencies to regularly analyze the performance and their methodology to produce the "best" possible ratings. He said that the issuer pay model provides the most rational and easy process to disseminate information.

Le Pallec said that competition for commercial approaches to credit ratings depends on structure, classes, and performance based on investor demand. He stated that rating performance is contingent on the time, class, and methodology, with a rank of risk and stability. He added that review of performance and the path to defaults are important for rating agencies to be transparent and predictable. Le Pallec suggested continuing to operate on the current issuer pay model, as he said it provides the highest level of public transparency and has the least amount of conflicts.

Otih stated that based on his experience with the credit rating process, the system was "smooth" and transparent for Mars to achieve its goals in the debt market. He said there were three credit rating agencies to choose from, and the policies for disclosures were clear. Otih suggested that reform to the current payment model would cause a potential conflict of interest for the relationship between investor and issuer transparency. He recommended not changing the current system, as a change could create the impression that certain agencies were being "favored" by issuers.

Sheffield said that GM has engaged in the unsecured and asset-backed security (ABS) market, which both require a good relationship with rating agencies and investors. She said that GM has a team of analysts that consider the pool of collateral and the historical performance of ratings to ensure a

“smooth” process. Sheffield said GM rotates between S&P Global, DBRS, Moody’s and Fitch to include two of the credit ratings on each transaction report for flexibility and consistency. She added that the issuer payment model, as an alternative to the current model, works “pretty well,” but depends on timing and flexibility for investors, as well as the consideration of fees and will change relationship structures in the process.

Wilson said that issuers respond to what investors need and want through consideration of costs and other dialogue. She noted that the analyst and rating agency relationship depends on fit, metrics and different levels of the process. Wilson stated that she would like to improve the current payment model and is concerned about the benefits.

Question & Answer

Clayton asked about the rigor of covenant-lite loans. Gates said there have been more covenant-lite loans in the market than ever before, and they provide issuers financial flexibility through their tight control. However, he said they do not address concerns of liquidity, but instead offer more leverage for issuers.

Redfearn asked about the pros and cons of sale side research. Sheffield said that sale side research is not helpful in the rating decisions process. She added that at times, there is non-public information that influences decisions and suggested working to create a more transparent process.

Michael Heaney, Chair of FIMSAC, asked about concerns of the multi-pay model. Le Pallec said that in “minority” instances credit rating agencies use the multi-pay model. He said credit rating agencies would have to adopt a transition in models and avoid potential conflict if this were to change. Gates said that a shift to such a model depends on impacts and its usefulness while preventing side effects.

Harris asked about learning from mistakes in the quality of ratings and how the review process works. Gates said that S&P publishes their tables for default rates annually and analyze the defaults for various reasons. He recommended placing ratings at the “right” level, implementing tools to prevent drastic movement of ratings, and maintaining the independence of the rating process. Le Pallec added that it is important to analyze rating transitions, as ratings should not drop more than one notch over a year.

For more information on this event, please click here.

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