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Bond Market's Toughest Problems Go Unresolved.

Regulators leave issues of credit-rating conflicts and trade transparency largely untouched.

The U.S. Securities and Exchange Commission's Fixed Income Market Structure Advisory Committee met earlier this week by webcast. For those in the bond markets who might have missed it, it's worthwhile to briefly note the takeaways from the group's virtual get-together.

To make a long story short, regulators punted yet again on some of the credit market's thorniest issues. For one, don't expect significant changes anytime soon to longstanding complaints about conflicts of interest in the "issuer pay" model of the ratings business. Also, forget about experimenting with the right balance of liquidity and transparency in corporate-debt trading.

The idea that the credit-ratings industry needs an overhaul is hardly new. Earlier this year, a bipartisan group of U.S. senators wrote to the SEC asking why it didn't reshape the business after the 2008 financial crisis. I predicted in February that elected officials and the fixed-income advisory committee would take their time and raise a bit of a fuss but ultimately do little to fundamentally fix the perceived conflicts.

Sure enough, the preliminary recommendation from the credit-ratings subcommittee for how to mitigate conflicts of interest passed easily but offered almost nothing that would alter the current model substantively. The three recommendations boiled down to this: greater disclosure from the ratings companies; more insight into how issuers pick their preferred credit-rating firms; and a vote by investors in publicly issued bonds to ratify the rating agencies selected by each issuer.

The first two are straightforward enough — basically, just more paperwork on each side explaining the process. The bondholder vote, however, is a bit more puzzling:

The Subcommittee recommends that the SEC explore a "ratification" of issuer-selected NRSROs. Periodically, holders of publicly-issued bonds should vote to ratify — or simply confirm confidence in — the NRSROs chosen by each issuer. Like the vote to ratify the public auditor, the election would be a simple up/down vote. The risk of censure that these votes would place on credit rating agencies could provide additional discipline to the quality of their work.

To be clear, when discussing conflicts in credit ratings, it's always about the temptation for "grade inflation" and never the other way around. A company or municipality will shop around for the highest ranking from the likes of S&P Global Ratings, Moody's Investors Service and Fitch Ratings and advertise it to investors to lower borrowing costs.

Current bondholders have virtually identical incentives to the issuer itself. Why would self-interested investors who are satisfied with their current position elect to "censure" a credit-rating firm for assigning a grade that's too high? In theory, such an action would cause the securities to drop in price. But I could certainly imagine a scenario in which bondholders would go after a ratings company for being too punitive — think a company that has investment grades from two rating companies but is considered junk by another.

The subcommittee, for its part, said it "recognizes that, even with the implementation of these recommendations, issues remain." Interestingly, it highlighted that "some investors own bonds that strictly meet their guidelines (e.g., investment grade, or "IG"), but which market participants know should be high-yield bonds." While that's probably just shorthand for market pricing, it's still a striking acknowledgment of the grade inflation that's an open secret in the current system.

Meanwhile, the Financial Industry Regulatory Authority made clear what was readily apparent months ago: Its plan to test whether delayed disclosure of large block trades in the corporate-bond market would boost liquidity has stalled. I wrote in January that the flurry of comment letters against the proposal, which were unyielding in their criticism, would likely leave Finra with no choice but to cast the proposal aside.

In something of an understatement, Tom Gira, Finra's executive vice president for market regulation and transparency services, noted that "it doesn't seem that we have the commenters' support here that would usually carry us forward on an important policy initiative." He said the regulator would study the market swings of the past few months to further inform its views of balancing bond-trading transparency and liquidity.

This is a thorny topic. On the one hand, fixed-income giants like BlackRock Inc. and Pacific Investment Management Co. clearly stood to gain more than smaller competitors from the plan, which would have given bond traders 48 hours to disclose block trades of more than $10 million in investment-grade bonds and more than $5 million in high-yield, instead of the current 15 minutes. As it stands, brokers might hesitate to make such large trades because others in the market will quickly know exactly how much changed hands and at what price.

Yet few investors would say the system is flawless. The huge fluctuations in exchange-traded funds tracking investment-grade and high-yield bonds during the worst of March's market tumult suggest there was little ability to trade large amounts of actual securities when needed. Finra's pilot program probably wasn't perfectly designed, and it could have made things weird for a short time, but it might have been worth it to bring empirical evidence to the debate about debt-market liquidity. Instead, traders are left with the same set of information as before.

Obviously, it's not worth messing with the bond markets "just because." Thanks in no small part to the Federal Reserve's recent interventions, they're functioning about as smoothly as ever. But these two topics are critical and have nagged investors for years. That there's still no clear path forward makes it seem as if these problems have no solution.

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