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A Big Bond Market Headache, Courtesy of the SEC.

Chair Gary Gensler wants to bring greater efficiency and transparency to debt trading, but an updated rule could do just the opposite.

U.S. Securities and Exchange Commission Chair Gary Gensler made waves in the fixed-income market earlier this week, signaling that he wants to find ways to "bring greater efficiency and transparency" to trading debt.

Yet beneath the surface, the regulator is just days away from potentially causing serious disruptions in those same bond markets.

An obscure SEC rule, 15c2-11, was amended a year ago for the first time in almost three decades. The change, which is meant to improve disclosure and investor protection in over-the-counter trading markets, sounds innocuous enough on its face. It ensures "that broker-dealers, in their role as professional gatekeepers to this market, do not publish quotations for an issuer's security when current issuer information is not publicly available."

There's one big problem: The rule, which had long been understood to safeguard retail investors from penny stocks and other "pump-and-dump" schemes, doesn't explicitly exclude fixed-income assets, except for municipal bonds. The Bond Dealers of America, a trade association for securities dealers and banks specializing in fixed income, says SEC staff have informally confirmed that the rule applies equally to both equities and debt.

"The industry is mildly freaking out," Kevin McPartland, head of research in Greenwich Associates' market structure and technology group, said in an interview. Firms must be compliant with the amendment on Sept. 28. "Dealers can't operationally make that happen in that span of time. If nothing changes, at the end of the month they may have to stop quoting some bonds," he said.

To get a sense of the level of panic, look no further than an Aug. 6 joint letter from the Securities Industry and Financial Markets Association and the BDA, which are seeking an exemption:

> "We are concerned that the rule as written could apply broadly to quotation activity for fixed income securities, and that the application of the rule to quotations for fixed income securities will deter that quotation activity in a way that will have a significant, deleterious effect on the fixed income markets. We believe that such an application of the rule is overbroad and unnecessary and will increase costs, decrease liquidity, and reverse the gains in transparency that the fixed income markets have achieved in recent years as the market has become more electronic."

In other words, this rule change could do precisely the opposite of what Gensler was advocating for in his prepared remarks before the Senate Banking Committee.

An earlier letter in May from the BDA details how it would affect certain corners of the bond market.

Non-government guaranteed mortgage-backed securities, for instance, are issued through trusts, meaning each transaction is unique. Under the amended rule, traders would have to review updates to each underlying pool of mortgages if they wanted to quote a price for a bond. Another example: A security is exempt from the rule if its average daily trading volume is at least $100,000 during the 60 calendar days before giving a price quote. That might save benchmark bonds from AT&T Inc., General Electric Co. and Microsoft Corp., but it could paralyze the secondary market for high-yield debt, where companies are more often private, smaller and opaque.

Throughout the letter, the BDA can barely hide its incredulity at the whole situation. The group summarizes its position like this:

> "The bond market simply is not the high risk, low transparency world of microcap stocks. Moreover, applying the Rule to fixed income would increase compliance costs for dealers, which ultimately would be reflected in higher transaction costs for investors. Finally, adding additional requirements before a firm can provide a quote or execute a trade for a customer could discourage firms from quoting certain securities altogether."

As far as I can tell, this looming compliance headache hasn't been discussed much anywhere, aside from these letters. That's likely because bond traders assumed the SEC couldn't possibly have intended to rope mortgage-backed securities and junk bonds into its Exchange Act Rule 15c2-11, given the gigantic size of those markets relative to a few hundred thinly traded stocks. Yet for now, that's exactly what it's doing.

"Until April of this year, I've never paid attention to this rule because this was not a fixed-income rule," Michael Decker, the BDA's senior vice president of federal policy and research, said in an interview. "The SEC has now taken the position that the rule already applies to fixed income and it has always applied."

The rule was changed when Jay Clayton was the head of the SEC. In a statement announcing the amendment, he applauded the long-overdue shifts to address fraud in markets with significant amounts of retail investors. That sure doesn't sound much like private-label MBS and high-yield debt, which are dominated by institutions.

"I don't think the SEC has thought through this," Decker said. In light of Gensler's recent remarks, "it's wise for everybody to take a few steps back, think about what enforcement policies will look like."

An SEC spokesperson didn't reply to an emailed request for comment.

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