Commentary: The Possibilities of Fixed-Income Exchanges

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Most corporate bond trading currently occurs in an over-the-counter market. Upon first impression, the reasons for this may seem obvious. Bonds generally are traded far less frequently than stocks. Absent an active market, an exchange listing may not be cost-effective. In addition, the complexity and sheer variety of available bond issues can be daunting, making them less suited for retail investors. Recently, there have been attempts to establish electronic exchange-based trading platforms which provide execution services and are targeted to retail investors.

Last month, the London Stock Exchange launched an electronic retail bond-trading platform. The LSE, citing "strong private investor demand," established the new exchange-based trading service to capture – some may say create – a retail investor market for fixed-income securities.

The LSE's goals are modest. It hopes that the new exchange will encourage issuers to target the retail audience specifically, by offering retail-friendly bonds in smaller lot sizes. The LSE is not alone in its belief that retail investors have an appetite to participate more fully in the bond market. Christine Lagarde, the French foreign minister, is leading the charge with more ambitious plans. France hopes to foster a bond-trading exchange platform based in Paris that will trade not only in French companies, but all types of euro-bonds.

Anticipating pan-European retail trading, the Deutsche Börse has also entered the ring. Its recent attempt to create a commission-free bond trading market on its Xetra electronic platform stalled shortly after launch, however, when a court in January imposed a preliminary injunction against the venture. Apparently, the selection process of specialist brokers, a key feature of the platform's continuous auction model, felled the exchange.

Wide-eyed optimists for the retail bond investor market, given the flurry of recent European activity, predict nothing short of a revolution in the world of corporate bonds. They envision a new order, where trading will gravitate from the opaque OTC market in which dealers and institutional investors dominate (and where the small-fry retail investor can get clobbered) to an investor friendly, transparent exchange market where it should be cheaper and easier to trade.

Contrarians with a "been there, done that" response to exchange-based bond trading should be forgiven. While exchanges might bring more transparency and lower trading costs to the benefit of retail and institutional investors alike, it is difficult to create an exchange market if market makers are not motivated to provide liquidity. Because many bonds rarely trade, most electronic bond trading platforms have been unsuccessful. Given their checkered past, why should these most recent efforts to establish bond exchange systems be any different?

Backers of these new initiatives may argue that their business model focuses on a specific market participant – the retail investor. But I'm skeptical that enough demand exists from the retail market to support widespread adoption of an exchange-based marketplace for bonds. It's true that small and large investors need each other. Small traders on an exchange can absorb larger positions unwound by dealers and institutions. Absent a belief that sufficient demand exists, however, large traders won't take their positions to the exchange in the first place.

The adage "liquidity begets liquidity" holds true. Traders will route their orders where they expect to find other orders. In addition, the OTC market is based on personal relationships. Large institutional investors have established relationships with broker-dealers and generally prefer to pick up the phone to negotiate a trade. Smaller investors have less bargaining power. History indicates it is unlikely that exchange markets will overtake the OTC markets in importance without support from large institutional investors.

Bonds have been traded over-the-counter for so long, it's hard to believe that it wasn't always this way.

In the U.S., the New York Stock Exchange commanded the municipal and government bond market until the Great Depression, when trading migrated to the OTC market. Trading in corporate bonds on the NYSE continued through World War II, when most of this trading also shifted over-the-counter. Academics attribute this shift to the increased importance of the institutional investor market, along with the diminished relevance of the retail customer. The NYSE has struggled, and largely failed, in its subsequent periodic attempts to regain trade volume in fixed-income securities.

Next month NYSE Bonds, the New York Stock Exchange's electronic bond-trading platform, will mark its third anniversary. The SEC exemptive relief that permits certain unregistered debt to trade on NYSE Bonds, provided these debt issuers have NYSE-listed equity, has certainly bolstered the exchange. All would agree the current exchange is an improvement over the Automated Bond System that NYSE Bonds replaced, which was hopelessly hamstrung by its limited inventory and regulatory registration requirements. NYSE Bonds has defied the odds thus far, despite the lack of specialists or dedicated market makers providing liquidity, in contrast to the platforms recently introduced or proposed by its aforementioned European counterparts. Still, long-run success is far from assured.

Technological innovation has transformed how business is conducted in the financial markets, with the equity markets in particular employing a variety of tools to improve price discovery and empower retail investors and market makers alike. Proponents advocate that transitioning to public, exchange-based trading will similarly democratize the bond market, enabling access to all investors, particularly retail investors who are more likely to traffic in small or odd-lot transactions.

One should applaud these efforts to increase the avenues available to the retail investor. But, the electronic-trading graveyard is littered with dozens of failed attempts to bring exchange-like attributes to the bond trading market. In order for an exchange-based platform to succeed, it will need more than retail investors and a handful of specialists. Enough volume needs to be generated to attract the institutional market to reach critical mass. Does sufficient demand exist to spur a transition to electronic, equity-style bond trading platforms? Recent history has not been kind. Some retail investors may visit, but most large investors will just pick up the phone and call.

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