

## **Commentary: Not Enough Sun Getting Through TRACE's Shutters**

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The famous quote of Supreme Court Justice Louis D. Brandeis, that “sunlight is the best of disinfectants,” has long set the tone for securities regulation in the United States. The SEC has followed this guiding principle in creating a system of regulation designed to ensure that the securities markets are transparent. Give investors accurate and complete information and, after that, get out of the way. The problem is, the FINRA TRACE system, which was intended to create a regulatory database and bring transparency to the over-the-counter bond market, has never fully opened its shutters to the public.

In October 2009, FINRA proposed amending its rules in order to define asset-backed securities, including mortgage-backed securities and other similar securities (“Asset-Backed Securities”), as TRACE-eligible, which would require the reporting of transactions in such securities to TRACE. In my view, this proposal is a step in the right direction because it broadens the range of securities that are subject to TRACE reporting. However, the proposal falls short because it contemplates that at this time no trade data for Asset-Backed Securities will be disseminated to the public.

FINRA’s decision to limit dissemination is not surprising, given that FINRA has limited the public disclosure of all other trade data reported to TRACE by establishing flawed dissemination protocols. These FINRA-conceived protocols violate FINRA’s own SEC-approved rules and are inconsistent with the intent of TRACE. For TRACE to provide market transparency and protect investors, FINRA must abandon these poorly conceived protocols and disseminate all trade data information to the public. Otherwise, FINRA’s current proposal, and TRACE in general, will continue to be of limited utility to many investors.

All FINRA member firms have an obligation to report transactions in eligible fixed income securities to TRACE pursuant to FINRA Rule 6730, and FINRA is required to disseminate trade data for all TRACE-eligible securities pursuant to FINRA Rule 6750. However, buried in FINRA’s TRACE User Guide are protocols pursuant to which FINRA withholds certain trade data from the public. These protocols specify that FINRA will withhold the actual numbers of bonds traded in investment grade debt with a par value above \$5 million and non-investment grade debt securities

with a par value greater than \$1 million, despite the fact that this information is reported to FINRA under Rule 6730.

FINRA and the SEC have repeatedly acknowledged the benefits to the investing public from the dissemination of real-time trade and volume data during market hours. For example, in 1992, in its comments to the proposed penny stock rules, FINRA indicated that increased dissemination would improve market visibility and price discovery. In 1997, with respect to trade reporting in foreign equity securities, the SEC noted that dissemination of trade reports would likely improve the ability of investors to monitor their executions in foreign securities.

Furnishing a trade report to FINRA so that FINRA may observe patterns of trading and otherwise conduct surveillance of the market is not sufficient to protect the investing public. It is as true now as in 1992 and 1997 that “sunlight is the best of disinfectants.” All material information contained on the trade report must be disseminated so that the investing public can monitor the behavior of their brokers.

FINRA Rule 6730 on Transaction Reporting currently requires reporting of transactions in TRACE-eligible securities. The information required to be reported includes, among other things, the actual number of bonds traded. FINRA Rule 6750 on Dissemination of Transaction Information provides that as soon as FINRA receives information on TRACE-eligible securities, it will disseminate that information to the public. The only transactions not required to be disseminated, according to this Rule are (i) transactions effected pursuant to Rule 144A under the Securities Act, (ii) transfers of certain proprietary positions effected in connection with broker-dealer mergers or consolidations and (iii) List or Fixed Offering Price Transactions and Takedown Transactions.

Although Rule 6750 requires dissemination of transaction information, FINRA disregards its own rule by instituting “dissemination caps” on the quantity of bonds traded. According to FINRA’s TRACE User Guide, “[f]or a reported trade [in Investment Grade debt] with a par value above \$5 million (more than 5,000 bonds), the quantity disseminated will be displayed as ‘5MM+’.... For a reported trade [in Non-Investment Grade debt (high-yield and unrated debt)] with a par value above \$1 million (more than 1,000 bonds), the quantity disseminated will be displayed as ‘1MM+’.” The actual volume is disseminated only for trades in Investment Grade securities in sizes less than or equal to \$5 million by par value and for Non-Investment Grade securities in sizes less than or equal to \$1 million by par value.

It seems likely that FINRA has decided to withhold volume information from the investing public not because of any systems limitations or technical reasons, but because FINRA-member firms participating in the debt market have resisted the complete dissemination of trade information required by Rule 6750. The industry

claims that dissemination would impair liquidity, although it seems that their real concern is with the resultant reduction of spreads and accordingly, profits. This is not the first time that investors have heard complaints from the industry that transparency would hurt liquidity, and time has proven such claims to be false, even for thinly-traded securities. Experience has taught us that disclosure benefits investors and improves markets, and that people who feel uncomfortable under the bring light of scrutiny often have something to hide.

I do not believe there is any valid justification, statutory or otherwise, for the imposition of these dissemination caps. The SEC and FINRA exist to protect the investor, not broker-dealer profits. It is contrary to the public interest to keep the public in the dark regarding the actual quantities of bonds traded. Moreover, there is no valid justification for the disparate treatment provided to Investment Grade and Non-Investment Grade debt with respect to these dissemination caps. Not only do these dissemination caps violate Rule 6750, but they are contradictory to certain provisions of Section 15A(b)(6) of the Securities Exchange Act. Section 15A(b)(6) requires, among other things, that FINRA rules be designed to (i) prevent fraudulent and manipulative acts and practices, (ii) promote just and equitable principles of trade, (iii) remove impediments to and perfect the mechanism of a free and open market and (iv) generally protect investors and the public interest.

Some of the investors most affected by FINRA's policies are value investors that buy non-investment grade debt that trades at significantly deep discounts to par (often at only a dollar or two per \$1000 par bond). When a large trade is executed, information relating to the exact number of bonds traded is vital to value investors in interpreting trade data. These investors generally view TRACE reports to make a best execution determination. Thus, it is essential for these investors to have complete transparency in trade information in order to properly evaluate whether they have received best execution with respect to any debt transaction in which they are participants, as well as to evaluate the market for possible business opportunities.

For example, suppose that 2,000 non-investment grade bonds trade at 1/2 of par (\$500). The total cost of the trade would be \$1,000,000, but the quantity (or volume) would only be reported as 1MM+. Based on the TRACE method of calculating quantity, par value multiplied by the number of bonds traded, the reported quantity should be 2,000,000. Now suppose that 5,000 bonds traded at 1/10 of par (\$100). The total cost of the trade would only be \$500,000, but the quantity of the trade would still be reported as 1MM+. Based on TRACE methodologies, the reported quantity should be 5,000,000. An investor trying to see whether he received a good execution from his broker would not be able to use this trade information to evaluate the quality of his execution, because the same information is disseminated for any transaction of 1,000 bonds or greater. Unless the information disseminated includes the quantity of bonds traded, an investor in

these bonds has no way of knowing whether he has received a bad execution. This problem is exacerbated with deeper discounts, as the 1MM+ limit is reached more quickly on bonds that trade at greater discounts to par, and it is more difficult for an investor to interpret information about a trade from the disseminated TRACE information.

FINRA and the SEC have recently been expanding other policies relating to dissemination of trade information, in order to create transparency in the markets. In recent past, FINRA and the SEC have broadened the scope of securities subject to reporting and dissemination through TRACE, instituted protocols to provide for the dissemination of last sale information in odd lots of high-priced OTC equity securities, aligned the dissemination protocols for all last sale reports of OTC equity transactions and expanded the TRACE dissemination protocols to publish the buy/sell and dealer/customer data elements, reasoning that this expansion would improve market transparency. The expansion of FINRA's protocol with respect to dissemination of the actual number of bonds traded would be consistent with the theories behind these recent changes to dissemination protocols.

Defining Asset-Backed Securities as TRACE-eligible will provide for increased price transparency in the market by broadening the range of securities trades that must be reported in the TRACE system. The SEC should require FINRA to disseminate trade information with respect to Asset-Backed Securities. More importantly, the SEC should first require FINRA to eliminate the dissemination caps on trade volume information. Disparate treatment with respect to dissemination of trade reports is detrimental to the investing public and the marketplace for debt securities. The transparency provided by complete dissemination of trade information would greatly enhance the ability of investors to monitor such markets, leading to more precise valuations, better pricing, and reduced investor costs. Providing industry participants with greater transparency will result in increased competition among broker-dealers with respect to executions and enhance best execution practices in the industry.

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