

July 8, 2022

Submitted electronically to: CBML-feedback@iosco.org

International Organization of Securities Commissions
Calle Oquendo 12
28006 Madrid
Spain
Attn: Mr. Martin Moloney, Secretary General

Re: Corporate Bond Markets—Drivers of Liquidity During COVID-19 Induced Market Stresses

Dear Mr. Moloney:

The Investment Company Institute (ICI) and ICI Global¹ welcome the opportunity to comment on the discussion paper from the International Organization of Securities Commissions (IOSCO) on the corporate bond markets and their experiences during the COVID-19 induced market stress of March 2020.² We believe the discussion paper, for the most part, provides a reasonable assessment of the corporate bond markets and the activity within those markets in March 2020. However, the paper’s examination of certain market participants—including US bond mutual funds—is rather limited. We believe a more comprehensive understanding of all market participants should precede any policy proposals relating to corporate bond markets or the market participants themselves.

With this submission, ICI is pleased to share our recent research on US bond mutual funds’ behavior—particularly with respect to purchases and sales of investment grade corporate bonds—in March 2020. According to ICI’s survey, US bond mutual funds sold only \$11 billion, net, of US investment grade corporate bonds in the first three weeks of March 2020. Further, we

¹ The Investment Company Institute (ICI) is the leading association representing regulated investment funds. ICI’s mission is to strengthen the foundation of the asset management industry for the ultimate benefit of the long-term individual investor. Its members include mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and UCITS and similar funds offered to investors in Europe, Asia and other jurisdictions. Its members manage total assets of \$29.6 trillion in the United States, serving more than 100 million investors, and an additional \$9.3 trillion in assets outside the United States. ICI has offices in Washington, DC, Brussels, London, and Hong Kong and carries out its international work through ICI Global.

² *Corporate Bond Markets – Drivers of Liquidity During COVID-19 Induced Market Stresses*, IOSCO Discussion Paper (April 2022) (“discussion paper,” or “paper”), available at www.iosco.org/library/pubdocs/pdf/IOSCOPD700.pdf.

estimate that these sales were associated with only a tiny fraction of the sharp increase in yield spreads on those bonds that month.

We also offer general and specific comments on corporate bond markets. We emphasize that securities regulators should seek to improve—and at a minimum, not impair—the ability of market participants to trade corporate bonds. We cite, as a problematic example to the contrary, the decision of the US Securities and Exchange Commission (SEC) to significantly restrict the ability of affiliated US registered funds to “cross trade” fixed-income securities with one another, notwithstanding the varied and substantial benefits that this activity provides to both funds (e.g., reduced transaction costs and improved portfolio management efficiency) and corporate bond markets generally (e.g., reduced demand on capacity-constrained dealers).

1. ICI’s Research on US Bond Mutual Funds’ Purchases and Sales of US Corporate Bonds in March 2020

Part C of the IOSCO discussion paper analyzes the supply of and demand for liquidity, including how market participants (e.g., insurance companies, pension funds, asset managers, and hedge funds) drove the demand for liquidity during the market stress and how dealers supplied liquidity to the market. On the “demand” side, it includes a sub-section on open-end funds (OEFs), and recognizes that, overall, their suspension activity in March 2020 was modest and restricted mainly to those OEFs invested in real estate. The discussion paper also concludes that during that time:

- Some OEFs contributed to selling pressure in some jurisdictions, driven by investor redemptions mostly related to the flight-to-quality and the dash-for cash.
- Many OEFs faced liquidity pressures, dealing with large outflows and deterioration in market liquidity.³
- To the extent that OEFs were not able to meet redemptions through free cash flow, there is evidence that some funds deployed a horizontal slicing approach (i.e., used cash and sold the most liquid assets first), which may have contributed to cash demand.

ICI has analyzed extensively the activity of US bond mutual funds (“bond mutual funds”) during March 2020. We offer our findings in this section to enrich the understanding of these market participants and help inform any potential policymaking.

In summary, our analysis shows that there is scant evidence that bond mutual funds’ activities during March 2020 amplified pressure in the US investment grade corporate bond market.

³ For instance, “In the US, investors withdrew more than \$200 billion from US taxable bond OEFs in March 2020.” Discussion paper at 22.

According to a unique ICI survey,⁴ bond mutual funds sold only \$11 billion, net, of US investment grade corporate bonds in the first three weeks of March 2020. Indeed, some respondents to ICI's survey, motivated by favorable prices, wanted to *buy* investment grade corporate bonds but were unable to locate sellers. Further, we estimate that the funds' very small net sales accounted for only a tiny fraction (7 basis points) of the sharp (313 basis points) increase in yield spreads on US investment grade corporate bonds that month.

These results contradict some policymakers' contentions that bond mutual funds amplified stresses in the investment grade corporate bond market during the pandemic-related turmoil of March 2020.⁵ They argue that to meet redemptions, bond mutual funds added to stresses by selling corporate bonds, implying that technical rather than fundamental factors played a dominant role.

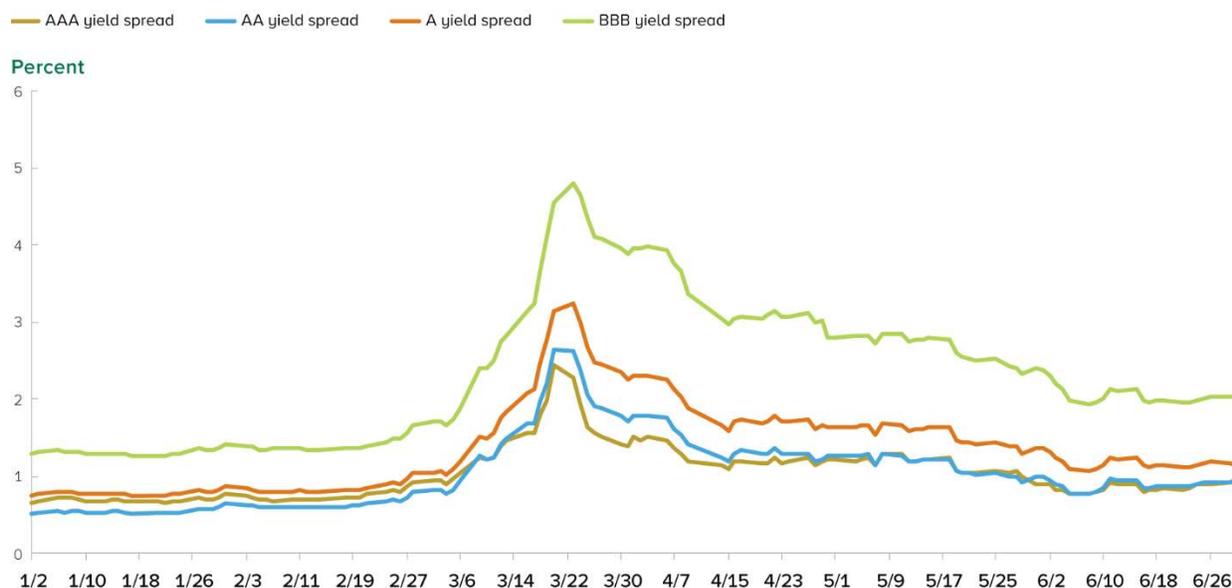
The data do not support this hypothesis. A far more compelling explanation for the jump in yield spreads is a rapid change in fundamentals stemming from concerns that the US economy could be rapidly headed into a deep and prolonged recession.

Amid the pandemic-induced turmoil of March 2020, the US investment grade corporate bond market came under considerable stress. Yield spreads on these bonds relative to the 10-year Treasury bond—a common gauge of strain in that market—widened substantially across the investment grade credit spectrum (Figure 1). The yield spread on AAA-rated US investment grade corporate bonds rose from 0.92 percent at the end of February 2020, to a peak of 2.44 percent on March 20, and the lowest-tier (BBB-rated) yield spread jumped from 1.67 percent to a peak of 4.80 percent on March 23.

⁴ To obtain a clearer picture of the events of March 2020, ICI conducted a comprehensive survey of its member firms. The survey gathered detailed daily data on bond mutual funds from February 28, 2020, through March 31, 2020—collecting the dollar amount of gross purchases, gross sales, and end-of-day holdings for a wide range of securities as well as net new cash flow and total net assets. For more information on the survey, see “ICI Bond Mutual Fund Survey Brings Facts to the Debate,” *ICI Viewpoints* (Feb. 24, 2022), available at www.ici.org/viewpoints/22-view-bondfund-survey-1.

⁵ See, e.g., Financial Stability Oversight Council Statement on Nonbank Financial Intermediation (Feb. 4, 2022) (asserting that asset sales by US open-end funds were a significant contributor to stress in US fixed income markets during March 2020); International Monetary Fund, *The Behavior of Fixed Income Funds during COVID-19 Market Turmoil* (Mar. 16, 2021) (stating that forced asset sales by open-end mutual funds amplified price pressures and contributed to liquidity falling across fixed-income markets, and that the drop in market liquidity may have played a role in encouraging further withdrawals from these funds). See also Stijn Claessens and Ulf Lewrick, *Open-ended bond funds: systemic risks and policy implications*, *BIS Quarterly Review* (Dec. 2021) (noting that the March 2020 market turmoil revived concerns about the amplification of financial stability risks by non-bank financial intermediaries, including open-ended bond funds).

Figure 1
Investment Grade Corporate Bond Market Under Stress During COVID-19 Turmoil
Yield spreads on investment grade corporate bonds; daily, January 2–June 30, 2020



Note: Yield spread is calculated as the yield on the ICE BofA US Corporate Index for each credit rating less the yield on the 10-year constant maturity Treasury.

Source: Federal Reserve Bank of St. Louis, Federal Reserve Economic Data (FRED)

1.1 Fundamental factors: macroeconomic pressures arising from COVID-19 developments

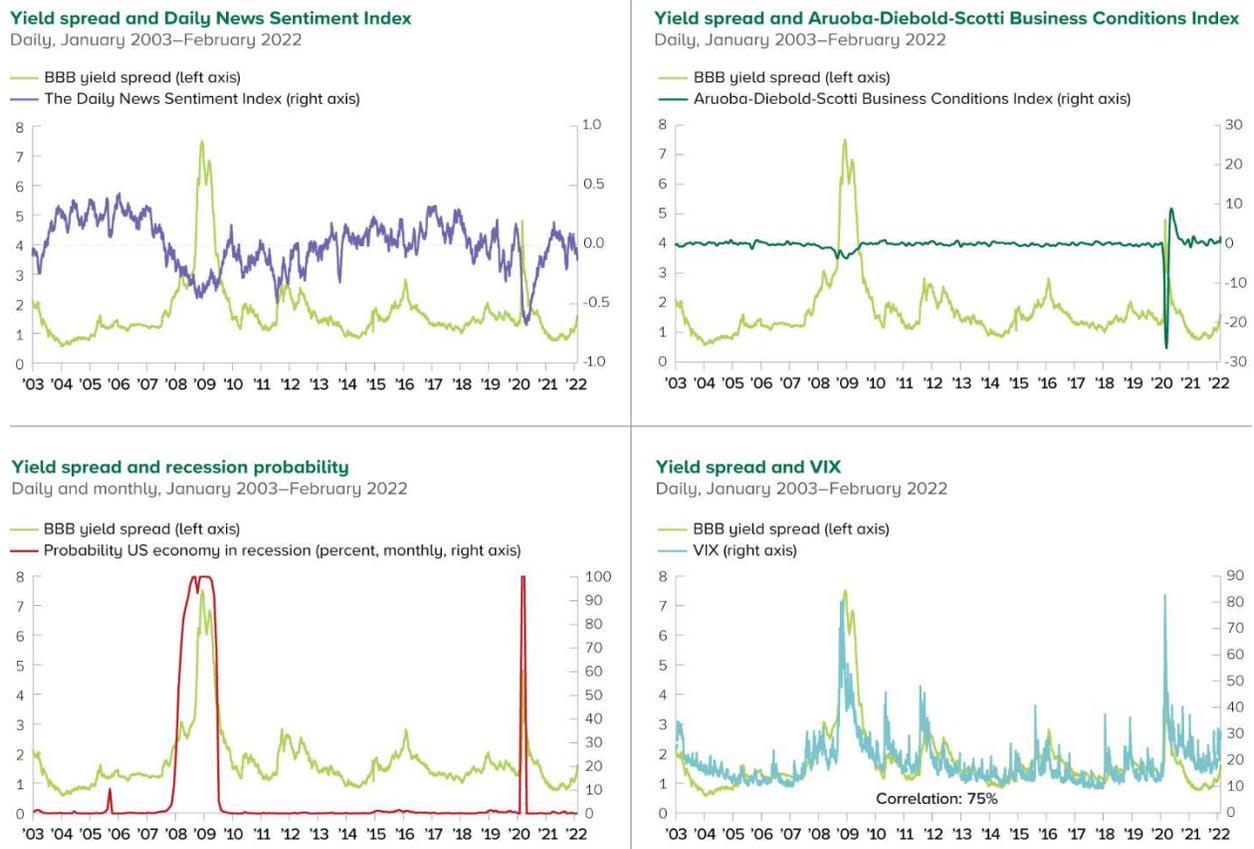
The arrival of the COVID-19 virus in the United States in early 2020—and the decision by authorities in mid-March to try to slow the spread by imposing social distancing measures—raised the specter of a deep and prolonged recession. Prospects for US businesses deteriorated because, with the economy locked down, companies were expected to suffer a sharp drop in sales and profits. In turn, businesses faced potential cash flow problems, creating the threat of widespread bankruptcies and debt defaults. Investor fear, as measured by the VIX index of stock market volatility, spiked. Accordingly, to compensate for these risks, market participants began demanding greater yields on US investment grade corporate bonds relative to US Treasuries.

Historically, yield spreads on corporate bonds have been associated with business cycle developments. As shown in Figure 2, news about the economy⁶ (upper left panel), business

⁶ The Daily News Sentiment Index is a high frequency measure of economic sentiment based on lexical analysis of economics-related news articles.

conditions⁷ (upper right panel), odds of the economy entering a recession⁸ (lower left panel), and uncertainty in the stock market (lower right panel) have been strongly related to the daily yield spread on BBB-rated US investment grade corporate bonds for the past two decades. Given the extreme macroeconomic factors experienced in March 2020, the jump in investment grade yield spreads was not surprising.

Figure 2
Yield Spreads on Corporate Bonds Are Linked to Economic Activity and Financial Market Uncertainty



Note: The BBB yield spread is calculated as the yield on the ICE BofA BBB US Corporate Index less the yield on the 10-year constant maturity Treasury.

Sources: Federal Reserve Bank of St. Louis, Federal Reserve Economic Data (FRED), Federal Reserve Bank of Philadelphia, and Federal Reserve Bank of San Francisco

⁷ The Aruoba-Diebold-Scotti business conditions index is designed to track real business conditions at high observation frequency. Its underlying (seasonally adjusted) economic indicators (weekly initial jobless claims; monthly payroll employment, monthly industrial production, monthly real personal income less transfer payments, monthly real manufacturing and trade sales; and quarterly real GDP) blend high-frequency and low-frequency data.

⁸ Chauvet, Marcelle and Piger, Jeremy Max, Smoothed U.S. Recession Probabilities [RECPROUSM156N], retrieved from FRED, Federal Reserve Bank of St. Louis.

1.2 Technical factors: bond mutual funds’ sales of corporate bonds during March 2020

Others, however, posit that the increase in corporate bond yield spreads related to the activities of bond mutual funds during March 2020.⁹ According to this hypothesis, bond mutual funds, and especially those that focus on investment grade corporate bonds, faced large investor outflows, which they sought to fulfill by selling corporate bonds. Because of this, the hypothesis continues, corporate bond prices fell and their yields rose (bond prices and yields move inversely with one another).

This hypothesis, however, generally gives short shrift to the possibility that conventional business cycle factors (as seen in Figure 2) may explain all or most of the rise in yield spreads in March 2020. Moreover, the data do not support this hypothesis. Daily data from ICI’s survey (which was undertaken in late 2021) show that during the height of the distress, bond mutual funds sold on net a small amount of US investment grade corporate bonds—only \$11 billion from February 28 to March 23, 2020 (Figure 3). Of this, the majority (\$8 billion) was attributable to “core bond mutual funds.” Much regulatory and academic scrutiny has focused on the activities in March 2020 of core bond mutual funds, to which we now turn our attention.

Figure 3
Bond Mutual Funds Sold Small Amounts of Investment Grade Corporate Bonds in March 2020
 February 28–March 23, 2020

ICI bond mutual fund category	Net purchases of investment grade corporate bonds
<i>All bond mutual funds</i>	<i>-\$11.0 billion</i>
Core bond mutual funds	-\$8.1 billion
Investment grade bond mutual funds*	-\$9.1 billion
Multisector bond mutual funds	\$1.0 billion
Other bond mutual funds	-\$2.9 billion

* ICI’s investment grade category includes ultrashort investment grade bond mutual funds.
 Source: Investment Company Institute

To understand how core bond mutual funds acted in March 2020, it is important to understand the structure of their portfolios. Many commentators mistakenly argue that these funds are “illiquid” because they assume these funds hold the great majority of their assets in corporate bonds. In fact, these funds hold roughly half their assets in the most liquid fixed-income instruments and a minority of their assets in investment grade corporate bonds. At the end of February 2020, assets in core bond mutual funds totaled nearly \$2.8 trillion (Figure 4, left panel).

⁹ See *supra*, note 5.

Only 28.1 percent of that total represented holdings of US investment grade corporate bonds. About half of the nearly \$2.8 trillion was in the most liquid fixed-income securities: US Treasuries (24.8 percent), US agency securities (17.3 percent), certain cash equivalents (4.5 percent), and “other assets” (5.9 percent) (which includes highly liquid instruments such as repurchase agreements, derivatives, and ETF shares).

Core bond mutual funds hold such a large portion of their assets in these highly liquid securities for a couple reasons. First, some funds’ investment objectives or policies require them to do so. For example, some large core bond mutual funds are index funds that seek to track the Bloomberg US Aggregate Bond Index, about two-thirds of which is allocated to US Treasury and agency securities. Another reason core bond mutual funds hold these highly liquid securities is to help them manage liquidity. The right-hand panel in Figure 4 shows that core bond mutual funds had \$125 billion in outflows from February 28 to March 23, 2020. To meet these redemptions, they primarily sold highly liquid assets, especially US Treasuries (\$58 billion), which represented 46 percent of their outflows.¹⁰ They also rolled off repurchase agreements, used reverse repurchase agreements, and sold other unidentified assets.¹¹

Some policymakers and academics have argued these funds depleted their liquid assets to the detriment of non-redeeming fund shareholders. But in fact, even after meeting the \$125 billion in redemptions, core bond mutual funds still held very substantial amounts of highly liquid assets. For example, their \$58 billion in net sales of US Treasuries was 8 percent of the \$690 billion they held. The story is similar for their holdings of US agency securities and cash equivalents: even after net sales or run-offs to meet redemptions, core bond mutual funds still had on hand substantial amounts of these highly liquid assets.¹²

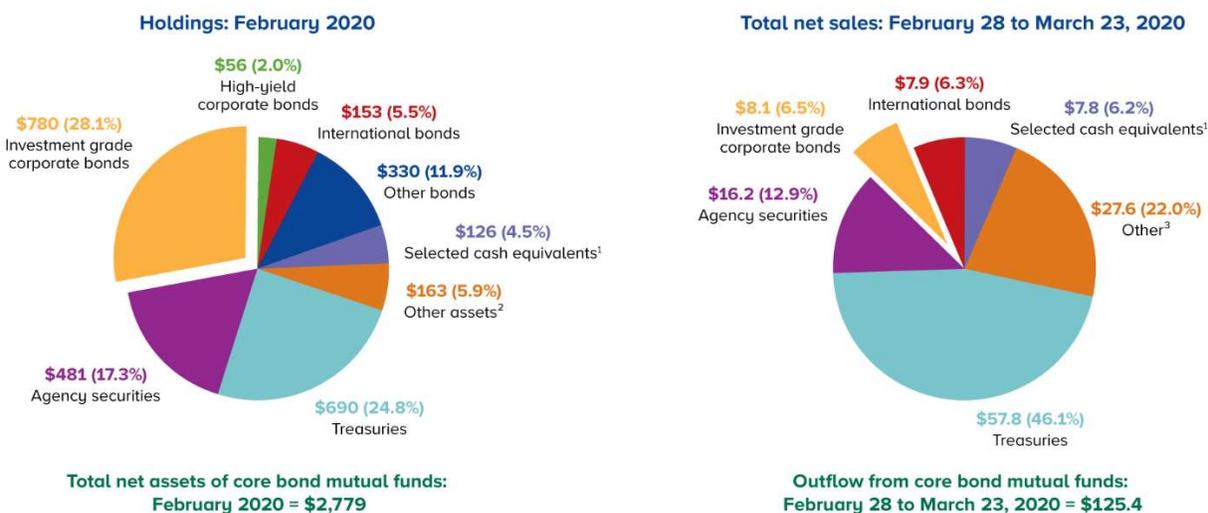
What *didn’t* core bond mutual funds sell much of? Investment grade corporate bonds. Their \$8 billion in net sales represented less than 7 percent of their total outflows during that time and was far less than in proportion to their February holdings.

¹⁰ See “Policymakers Say Bond Mutual Funds Contributed Significantly to Treasury Market Stress but...,” ICI Viewpoints (March 24, 2022), which presents evidence that bond mutual funds’ sales of Treasuries had only a minimal impact on the Treasury market during this period. Available at www.ici.org/viewpoints/22-view-bondfund-survey-3.

¹¹ Funds also may have met redemptions in part with cash generated from their portfolio holdings through interest income, bonds maturing, or prepayments of principal.

¹² During market downturns, market forces can actually bolster the proportion of these funds’ assets in highly liquid securities, such as cash, cash equivalents, and Treasuries and agencies. This can happen if, for example, the prices of Treasury and agencies fall less than prices of corporate bonds (as would typically be the case during a downturn). All else equal, that would automatically boost the proportion of a fund’s assets in Treasuries and agencies and lower its proportion in corporate bonds.

Figure 4
Core Bond Mutual Funds Hold Highly Liquid Assets and Sold Them for Various Reasons in March 2020
 Billions of dollars



¹This category is the sum of commercial paper, certificates of deposit, money market fund shares, and Treasury bills.

²Other assets includes other cash equivalents, repurchase agreements, bank loans, ETF shares, market value of derivatives positions, and any assets not represented in the identified categories.

³Other reflects other sources funds may have used to meet outflows, such as interest income, proceeds from matured bonds, rolling off repurchase agreements, using reverse repurchase agreements, and net sales of other assets.

Note: Core bond mutual funds are ICI's categories of investment grade (which includes ultrashort funds) and multisector bond mutual funds.

Source: Investment Company Institute

In fact, during this period, some core bond mutual funds—believing that US investment grade corporate bonds were undervalued relative to US Treasuries—sought to *buy* investment grade corporate bonds but found it difficult to do so. One explanation may be that by mid-March, other market participants also came to view US investment grade corporate bonds as a good value and were therefore reluctant to sell. Another difficulty, which some survey respondents cited, is that dealers, seeking to preserve their balance sheet capacity, shifted from intermediating corporate bonds on a principal basis to an agency basis. With agency trades, the dealer must find and bring together both a seller and a buyer, which can take time, thus slowing trading and making it more challenging for both sellers *and* buyers.

1.3 Fundamental Factors Explain Virtually All of the Increase in US Investment Grade Corporate Bond Yield Spreads in March 2020

Our survey results, combined with academic research, strongly suggest that core bond mutual funds' small sales of US investment grade corporate bonds added only marginally to the very substantial run-up in yield spreads in March 2020. Instead, the jump is highly consistent with a market-wide repricing of assets in response to the rapid deterioration in macroeconomic

fundamentals stemming from concerns that the US economy could be headed into a deep and prolonged recession.

We arrive at this conclusion by combining our survey results with those from an academic study of the corporate bond market in March 2020 done by V. Haddad, A. Moreira, and Tyler Muir (2021).¹³ Their results, which use FINRA's TRACE transaction-level data on corporate bonds, suggest that bond mutual funds' net sales of corporate bonds accounted for about 10 percent of the increase in yield spreads, with the remainder due to fundamental factors or other technical factors.

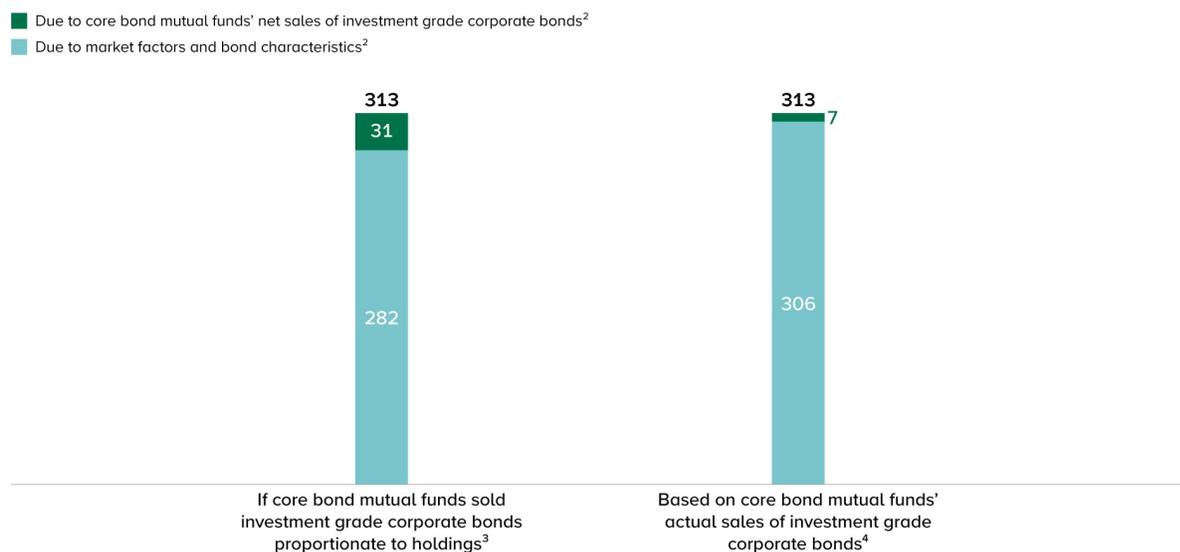
In deriving this result, the authors assume bond mutual funds sold US corporate bonds in proportion to their February 2020 holdings. On this basis, core bond mutual funds' net sales of US investment grade corporate bonds might have accounted for 31 basis points of the 313 basis point increase in the yield spread on BBB-rated investment grade corporate bonds from February 28 to March 23 (Figure 5, left-hand bar). For more detail, see note 3 in Figure 5.

But, as shown by ICI's survey data, core bond mutual funds in fact sold US investment grade corporate bonds far less than in proportion to their holdings (see Figure 4). Applying the results of Haddad et al. to the ICI survey data, we conclude that core bond mutual funds' net sales of US investment grade corporate bonds accounted for a miniscule part (7 basis points) of the 313 basis point rise in BBB yield spreads from February 28 to March 23 (Figure 5, right-hand bar). In other words, yield spreads on US investment grade corporate bonds rose almost entirely either because of fundamentals or other technical factors. For more detail, see note 4 in Figure 5.

¹³ V. Haddad, A. Moreira and Tyler Muir, "When Selling Becomes Viral: Disruptions in Debt Markets in the COVID-19 Crisis and the Fed's Response," *Review of Financial Studies*, 34, 2021.

Figure 5
Fundamentals Account for Nearly All of the Increase in Investment Grade Yield Spreads in March 2020

Increase in BBB yield spread,¹ basis points, February 28–March 23, 2020



¹The BBB yield spread is calculated as the yield on the ICE BofA BBB US Corporate Index less the yield on the 10-year constant maturity Treasury.

²Estimates based on Haddad et al. (2021), table 6, page 5342 and appendix table IA.1 on appendix page 73. Haddad et al. (2021) use daily data on individual corporate bonds for March 2020 to assess the influence of various factors on corporate bond yield spreads in March 2020.

³Consistent with Haddad et al. (2021), the estimate assumes that to meet redemptions in March 2020, core bond mutual funds sold proportionate slices of all the asset types in their portfolios. Their results indicate that mutual funds' net sales of corporate bonds accounted for about 10 percent of the total increase in yield spreads of investment grade corporate bonds over Treasuries from February 28 to March 23. Thus, their results suggest 31 basis points (10 percent) of the 313 basis point rise in the BBB yield spread is attributable to bond mutual funds' sales of investment grade corporate bonds.

⁴The estimate is based on Haddad et al. (2021), but is corrected to more accurately capture core bond mutual funds' actual selling activity (i.e., they sold a less-than-proportionate slice of their investment grade corporate bonds in March 2020). Using ICI's survey, core bond mutual funds did not sell a pro rata slice of their assets and therefore did not sell \$35.2 billion in investment grade corporate bonds. In reality, these funds sold just \$8.1 billion, or 23 percent, of the assumed \$35.2 billion pro rata slice. As a result, we scale the estimated 31 basis point impact down to 7 basis points (31 basis points * 0.23).

Note: Core bond mutual funds are ICI's categories of investment grade (which includes ultrashort funds) and multisector bond mutual funds.

Source: Investment Company Institute

1.4 Daily Pattern of Core Bond Mutual Funds' Transactions in US Investment Grade Corporate Bonds During March 2020

During the height of the crisis in March 2020, core bond mutual funds, on a daily basis, were relatively small net sellers of US investment grade corporate bonds. In addition, the timing of these daily net sales is inconsistent with the hypothesis that bond mutual funds contributed significantly to the stress in the US investment grade corporate bond market.

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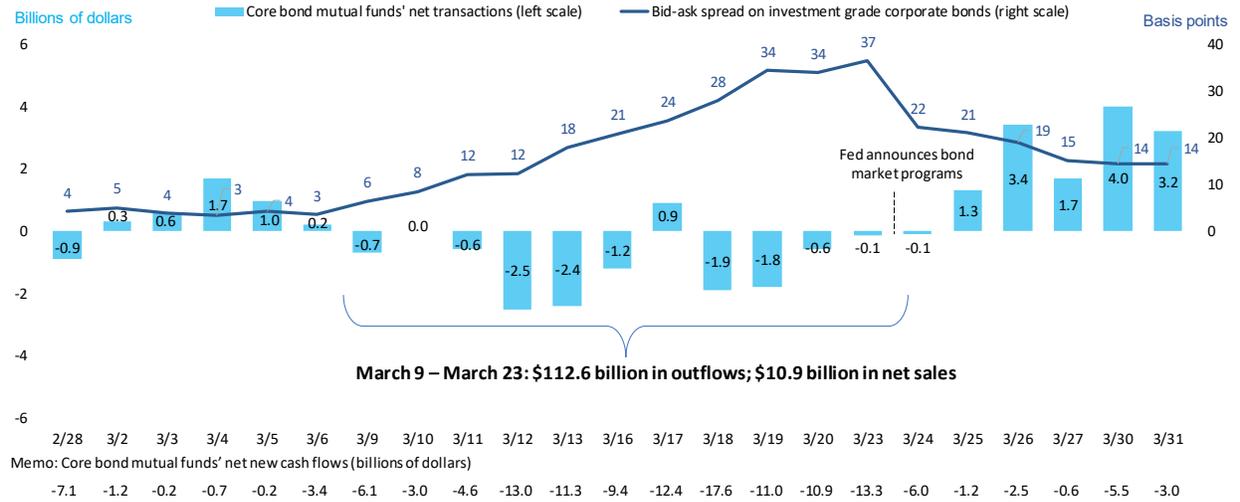
Figure 6 shows core bond mutual funds' daily net purchases or sales of US investment grade corporate bonds (shown as the blue bars). Core bond mutual funds are net buyers when the bar is above zero and net sellers when it is below. The solid blue line is the bid-ask spread on US investment grade corporate bonds. The bid-ask spread is often used to gauge liquidity pressure in a market. If the narrative is correct that core bond mutual funds added substantially to stress in the US investment grade corporate bond market, widening of the bid-ask spread would be expected to be most evident on days when core bond mutual funds sold most heavily.

This correlation is far from clear. The bid-ask spread starts widening on March 9, 2020, and while core bond mutual funds turn from being net buyers to net sellers, their net sales are quite small—\$700 million at most—over each of the next few days. Moreover, it is questionable whether core bond mutual funds' daily net sales are driving the bid-ask spread. For example, over the next three business days, March 12 to March 16, funds' net sales are larger (although still rather small in dollar terms). Nevertheless, the bid-ask spread widens by nine basis points—the same amount by which it increased over the three-day period from March 9 to March 11, when funds' net sales were considerably smaller. Then, on March 17, these funds were net *buyers* of \$900 million in US investment grade corporate bonds. Presumably, if funds' net sales were driving market stress, the bid-ask spread should have *narrowed* on that day. But the bid-ask spread widened further by three basis points. Later in the month, after the Federal Reserve announced programs to support the US investment grade corporate bond market, core bond mutual funds returned to being net buyers. But in the critical period March 9 to March 23, core bond mutual funds, net, sold only \$10.9 billion in US investment grade corporate bonds.

Figure 6

Timing of Core Bond Mutual Funds' Investment Grade Corporate Bond Sales Is Inconsistent with Stress Amplification

Daily, February 28–March 31, 2020

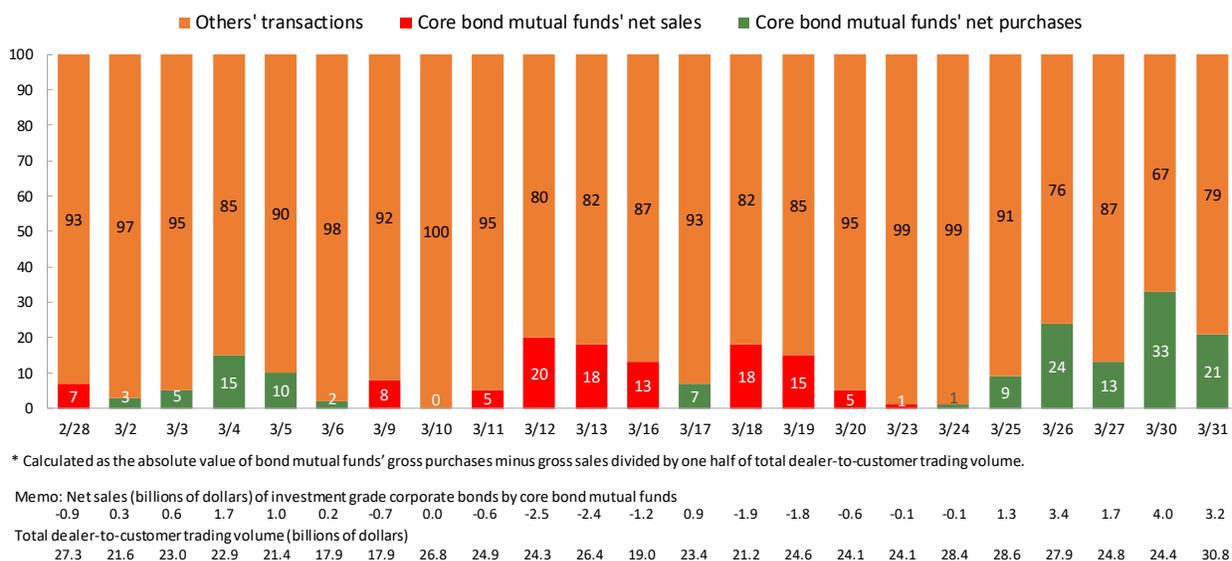


Note: Core bond mutual funds represent ICI's categories of investment grade (which includes ultrashort funds) and multisector bond mutual funds.

Source: Investment Company Institute and MarketAxess

How did these net sales of US investment grade corporate bonds by core bond mutual funds compare to broader trading volumes in the US investment grade corporate bond market in March 2020? For the most part, core bond mutual funds' net sales accounted for a relatively small share of overall dealer-to-customer trading volume. From March 9 to March 11, they accounted for at most 8 percent of trading volume (Figure 7). From March 12 to March 16, their proportion of trading volume did increase, but the evidence is inconclusive about what effect this might have had. For example, on March 12, the day funds' share of the trading volume peaked (at 20 percent), the lack of a widening of the bid-ask spread on that day (as seen in Figure 6) indicates that selling conditions did not deteriorate that day.

Figure 7
Core Bond Mutual Funds' Net Sales Accounted For a Relatively Small Share of Trading
 Percent of daily trading volume in investment grade corporate bonds,* February 28–March 31, 2020



Note: Core bond mutual funds represent ICI's categories of investment grade (which includes ultrashort funds) and multisector bond mutual funds.

Source: Investment Company Institute and FINRA

1.5 Summary of ICI Survey Results for Investment Grade Corporate Bonds

Some policymakers have repeatedly claimed that bond mutual funds, faced with historically high outflows during March 2020, amplified or contributed significantly to stresses in fixed-income markets. We are pleased that IOSCO's discussion paper is cautious about repeating such claims. Nevertheless, these kinds of unfounded claims from other policymakers appear to be leading to proposed reforms that will have detrimental consequences for bond mutual funds and their investors. Our analysis underscores the importance of *quantifying* the size of the amplification. In the case of core bond mutual funds' impact on the US investment grade corporate bond market in March 2020, it was immaterial.

2. General Comments on Corporate Bond Markets

Buy-side market participants (e.g., open-end funds) traditionally trade corporate bonds in the dealer-to-customer market through bilateral negotiations with dealers or other intermediaries (over the phone or through other means of communication). Trading corporate bonds in this way is commonplace, and often requires funds to reach out to more than one dealer to execute a trade.

More recently, electronic trading platforms that include request-for-quote protocols and similar functionalities allow funds to efficiently request and obtain competitive quotes from a selected number of liquidity providers. Further, electronification has led to more sophisticated execution and order management systems that can centralize multiple trade execution protocols, aggregate and assess liquidity across different data feeds for multiple instruments, and allow users to bilaterally communicate and negotiate with different liquidity providers.¹⁴ Electronification has provided greater trading and operational efficiencies for funds, which benefit fund shareholders through improved execution and lower costs. ICI supports these developments, along with a regulatory framework that will foster continued growth and innovation in the corporate bond and other fixed-income markets.¹⁵

Despite these recent positive developments, the fixed-income markets remain fragmented. Funds often need multiple avenues for successfully carrying out different trading strategies—one means of trading, or even a few, may not suffice. This is due in part to the number, variety, and complexity of fixed-income issues, which in turn affects tradability. Corporate bond liquidity, for example, varies from bond to bond due to the sheer number of different issues and the diverse nature of these instruments.¹⁶ That liquidity may shift even more during periods of market stress, which requires the ability for funds and other buy-side market participants to select among these different protocols or rely on traditional over-the-counter trading methods, as necessary, to source interest.¹⁷

Certain developments and trends affecting fixed-income trading over the past decade or so have contributed to additional challenges in trading fixed-income securities. Dealer inventories of fixed-income securities (particularly corporate bonds) have significantly decreased, thereby

¹⁴ Investment advisers and other buy-side market participants use order and execution management systems (OEMSs) to carry out investment activities on behalf of funds and other clients. An OEMS allows a user to perform a broad range of complex functions across the entire investment process, including investment data research and analysis, identification of liquidity in different marketplaces, monitoring of real-time market conditions, order instruction routing to different trading venues, and post-trade processing and execution analysis. Increased electronic trading in recent years has led to more innovative OEMS product offerings that facilitate greater market participation in traditionally less liquid markets. *See* Letter from Sarah Bessin, Associate General Counsel, and Nhan Nguyen, Assistant General Counsel, ICI, to Vanessa Countryman, Secretary, SEC (Apr. 18, 2022), at 4-5, available at www.ici.org/system/files/2022-04/34120a.pdf.

¹⁵ *See generally* Letter from Sarah Bessin, Associate General Counsel, and Nhan Nguyen, Counsel, ICI, to Vanessa Countryman, Secretary, SEC (Mar. 1, 2021), available at www.ici.org/pdf/33146a.pdf.

¹⁶ The discussion paper notes that the World Federation of Exchanges estimates that there are globally about 48,000 stocks, and CUSIP Global Services estimates that there are over 515,000 corporate bonds in the US alone. Discussion paper at 34.

¹⁷ During periods of high market volatility such as March and April of 2020, market participants used both electronic and non-electronic means of trading. For example, anecdotal evidence suggests that buy-side market participants sought liquidity through electronic trading platforms after dealers stopped quoting prices over the phone. Some ICI members, however, reported that they resorted to traditional voice trading methods because dealers limited auto-streaming of quotes over electronic protocols.

affecting how funds and other buy-side participants to source liquidity. Citing work by the Federal Reserve Bank of New York, in 2020 the SEC's Division of Economic and Risk Analysis (DERA) noted that "dealer [corporate bond] balance sheets have declined from approximately \$225 billion around the time of the 2008 [Global Financial Crisis (GFC)] to about \$50 billion today and generally are focused on more liquid aspects of the market."¹⁸ DERA explained that following 2008, dealers moved toward an agency model (helping to match buyers and sellers), while no longer committing a large portion of their balance sheets to holding inventory, which has reduced the liquidity they provide.

Moreover, dealers' ability or willingness to commit their balance sheets to providing fixed-income market liquidity appears to be adversely affected by market conditions. Citing the work of the Federal Reserve Bank of Philadelphia on dealer inventory, DERA posited that dealer inventories in corporate bonds began declining in early March, and dealers only began accommodating customer demand again (by absorbing more inventory) after the Federal Reserve provided certain capital relief to regulated banks and introduced the Primary and Secondary Market Corporate Credit Facilities later in the month.¹⁹ Similarly, ICI's 2020 analysis of the impact of COVID-19 on financial markets found that, since late 2018:

- dealers' inventories of Treasury bonds and mortgage-backed securities (MBS) had been rising, in part because the US Treasury issued debt to finance the mounting US fiscal deficit;
- in late February and March 2020, as dealers tried to intermediate the increased sales of Treasury bonds and MBS, their net inventories of Treasury bonds and agency pass-through residential MBS spiked; and
- dealers' increased holdings of Treasury and MBS likely limited their ability to intermediate trades in other fixed-income assets, such as corporate bonds.²⁰

In sum, funds avail themselves of multiple means of trading corporate bonds. As we discuss below, this includes cross trading, a valuable complement to other traditional and evolving trading functionalities and protocols.

¹⁸ *U.S. Credit Markets, Interconnectedness and the Effects of the COVID-19 Economic Shock*, SEC Division of Economic and Risk Analysis (October 2020) ("DERA Report"), at 33, available at www.sec.gov/files/US-Credit-Markets_COVID-19_Report.pdf.

¹⁹ DERA Report at 37.

²⁰ *Report of the ICI COVID-19 Market Impact Working Group, The Impact of COVID-19 on Economies and Financial Markets* (October 2020), at 30–32, available at www.ici.org/pdf/20_rpt_covid1.pdf.

3. ICI Strongly Recommends that Securities Regulators Permit Flexibility in Means of Trading Corporate Bonds

The discussion paper asks if there are ways to improve market functioning and liquidity provision in corporate bond markets, notably under stressed conditions. It also asks, “Considering the drivers of dealer behavior, how could the supply of liquidity be improved?”²¹

IOSCO is right to ask these questions and take an expansive view of liquidity provision in the corporate bond markets. Based on some of the challenges and limitations in the corporate bond markets described in the discussion paper and above—especially regarding the reduced capacity of dealers to intermediate trades for all market participants—securities regulators and other policymakers should consider how other trading avenues could be expanded or protected to facilitate trading of corporate bonds, such as the promotion of “all-to-all” trading. At the very least, regulators should not impair the ability of funds and other market participants to trade corporate bonds.

In the US, the SEC is not taking this commonsense approach. Notwithstanding a statutory prohibition on affiliated transactions for US registered investment companies (“US funds”), for decades affiliated US funds have relied on the SEC’s Rule 17a-7 to “cross trade” fixed-income securities (including corporate bonds) with one another to avoid costs that each would otherwise incur if transacting on the open market.²²

We know that cross trading corporate bonds (and fixed-income securities generally) benefits US funds, provided that the trades are consistent with each fund’s investment objectives and strategies and accurately priced. Cross trades eliminate dealer costs, and as noted below and based on ICI survey data, we estimate that these corporate bond cross trades saved US advisers’ clients (including US funds) \$278 million in 2020. We know that cross trading facilitates efficient portfolio management and compliance with investment policies.²³ We know that cross trading is an important complement to transacting through dealers, particularly in times of stress—according to our survey, most respondents’ cross trading activity was either

²¹ Discussion paper at 41-42.

²² Section 17(a) of the Investment Company Act of 1940 prohibits any affiliated person of a US fund, or any affiliated person of such a person, from selling securities to, or purchasing securities from, the fund. This broad statutory prohibition reflects the policy concern for potential abuses that may accompany affiliated transactions. For instance, one fund could “dump” unwanted securities into another fund, or the transaction could be priced in a way that favors the buying or selling fund. The SEC also amended the cross trading rule several times since adopting it in 1966, generally to expand both the universe of securities eligible for cross trading and the conditions that funds must follow. SEC staff no-action letters also have facilitated cross trading, with the most prominent letters allowing funds to cross trade municipal securities using evaluated prices (i.e., prices provided by an independent third-party pricing service).

²³ See Section III.B of the ICI Fixed-Income Cross Trading Report, *infra* note 27, for more information.

approximately the same (41 percent) or higher (46 percent) in March and April of 2020 as compared to the remainder of 2020. To the extent that dealers' capacity to intermediate corporate bond transactions has decreased over the years and has not been sufficiently responsive to stressed conditions (e.g., in March 2020), alternatives such as cross trading help relieve the strains that all market participants feel as a result. Using IOSCO's framing, cross trading lessens US funds' demand on dealers for liquidity and helps alleviate (in IOSCO's words) "supply side market constraints" and more limited "elasticity of supply of liquidity by dealers."²⁴

In spite of all of this, in December 2020 the SEC issued cross trading guidance in the adopting release for new Rule 2a-5 (the "fair value rule")²⁵ that will significantly disrupt existing cross trading activities that have been benefitting US fund shareholders for decades.²⁶ Assuming the SEC takes no further action prior to the compliance date for this guidance (September 8, 2022), funds' ability to cross trade fixed-income securities will be severely restricted.²⁷

As noted above, ICI provided the SEC with comprehensive data on fixed-income cross trading for calendar year 2020, based on an extensive member survey.²⁸ With respect to corporate bonds:

- Thirty-three percent of respondents reported cross trading activity in **investment grade corporate bonds** in 2020. Those that cross traded these bonds reported 12,025 distinct cross trades, totaling \$71 billion. We estimate that these trades saved funds \$222 million, and investment advisers' clients generally \$255 million.²⁹
- Twenty-nine percent of respondents reported cross trading activity in **high yield corporate bonds** in 2020. Those that cross traded these bonds reported 10,169 distinct cross trades, totaling \$5.9 billion. We estimate that these trades saved funds \$17 million, and investment advisers' clients generally \$23 million.

²⁴ Discussion paper at 2 and 31.

²⁵ *Good Faith Determinations of Fair Value*, SEC Release No. IC-34128 (Dec. 3, 2020) ("Fair Value Rule Adopting Release"), at 88-95, available at www.sec.gov/rules/final/2020/ic-34128.pdf.

²⁶ To be eligible for cross trading, a security must have a "readily available market quotation." But under the SEC's new definition of this term (which applies for purposes of both the fair value and cross trading rules), few fixed-income securities have "readily available market quotations" and therefore, US funds' ability to cross trade fixed-income securities would be severely restricted.

²⁷ See generally *Rule 17a-7 at the Crossroads: The Right Path Forward*, Investment Company Institute (April 2021) ("ICI Fixed-Income Cross Trading Report"), available at www.sec.gov/file/investment-company-institute.pdf.

²⁸ Fifty-two ICI member firms responded, representing more than \$23 trillion, or approximately 71 percent of US-registered fund assets, as of December 31, 2020.

²⁹ We estimated cost savings by applying bid-ask spread estimates (a proxy for transaction cost savings) for each asset class to the total dollars cross traded in each asset class. See Appendix A of the ICI Fixed-Income Cross Trading Report for more information on this methodology.

Nearly all of these cross traded corporate bonds were classified by respondents as Level 2 securities under the US generally accepted accounting principles (GAAP) fair value hierarchy,³⁰ which means that under the new SEC guidance, virtually all of these trades will be prohibited.

Reform of the cross trading rule had been on the SEC's rulemaking agenda since 2019, and in 2020 the Technology and Electronic Trading Subcommittee of the SEC's Fixed-Income Market Structure Advisory Committee (FIMSAC) recommended that the SEC amend Rule 17a-7 to facilitate funds' ability to cross trade fixed-income securities.³¹ Despite initially indicating that it would continue work on the cross trading rule³² and receiving detailed data and policy recommendations from ICI and others, the SEC dropped the item from its rulemaking agenda without explanation in December 2021, over the objections of two SEC Commissioners.³³

We understand that affiliated transactions present potential risks and conflicts of interest.³⁴ But given the tangible, varied, and substantial benefits that cross trading provides, the logical policymaking step is to seek to capture those benefits and attach appropriate conditions to mitigate the potential risks.³⁵ The SEC's refusal to do so is perplexing, particularly given the SEC Chair's emphasis on "resiliency"³⁶ and the SEC's extensive experience and skill with

³⁰ See *supra*, note 26.

³¹ *Preliminary Recommendation Regarding Modernizing Rule 17a-7 under the 1940 Act* (June 1, 2020), available at www.sec.gov/spotlight/fixed-income-advisory-committee/preliminary-recommendation-rel17a-7.pdf.

³² See Fair Value Rule Adopting Release at 95 ("[C]onsideration of potential revisions to rule 17a-7 is on the rulemaking agenda. We welcome input from the public as we undertake our consideration of rule 17a-7."); see also *Staff Statement on Investment Company Cross Trading*, SEC Division of Investment Management Staff (March 11, 2021), available at www.sec.gov/news/public-statement/investment-management-statement-investment-company-cross-trading-031121 ("In addition, as the Commission stated in adopting the Valuation Rule, consideration of potential amendments to rule 17a-7 is on the rulemaking agenda. ... We believe that funds' cross trading practices have evolved over the last several decades and, accordingly, we believe it is once again appropriate to assess what, if any, changes to rule 17a-7 may be warranted.")

³³ *Falling Further Back—Statement on Chair Gensler's Regulatory Agenda*, Commissioners Hester M. Pierce and Elad L. Roisman (Dec. 12, 2021), available at <https://www.sec.gov/news/statement/peirce-roisman-falling-further-back-121321> ("the [SEC's Rulemaking] Agenda abandons the much-needed effort to amend Investment Company Act Rule 17a-7... Commenters have been nearly unanimous in conveying the importance of funds' ability to trade fixed-income securities across affiliated funds. Many commenters also have recommended conditions to ensure the protection of fund investors. ... Yet now, despite the demonstrated need for such amendments, the Agenda simply drops the planned rewrite of Rule 17a-7. As a consequence, we will not fix a problem of which we are aware—the impending inability of funds to cross-trade fixed-income securities—and we will miss a chance to modernize an outdated rule.")

³⁴ See *supra*, note 22.

³⁵ See Section VI of the ICI Fixed-Income Cross Trading Report for policy recommendations and ways to mitigate risks of fixed-income cross trading.

³⁶ See, e.g., *Testimony at Hearing before the Subcommittee on Financial Services and General Government U.S. House Appropriations Committee*, SEC Chair Gary Gensler (May 17, 2022), available at www.sec.gov/news/testimony/gensler-testimony-fsgg-subcommittee.

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rulemaking, exemptive relief, and interpretive guidance related to affiliated transactions. The concerns identified in IOSCO's discussion paper only bolster the case for the SEC to resume its work here, which would be an obvious and efficient way to augment dealer-provided liquidity.

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We sincerely appreciate your consideration of our comments. If you have any questions, please do not hesitate to contact the undersigned at 202.326.5882 or 202.326.5910, respectively.

Respectfully submitted,

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