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STA Open Call – May 21, 2020
Fixed Income ETFs; When Market Structures Collide
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Reference Material[1]

Delisting Chinese Companies - Senate & House Bills

The combination of the Senate passing S. 945, Holding Foreign Companies Accountable Act and a similar, companion bill being introduced on the House side signals strong bipartisan support and therefore indicates a greater, but not absolute, likelihood that a final bill will be sent to the president for final approval. The current versions of the bills, among other things, require the SEC to prohibit trading of the securities of a foreign company if the PCAOB is unable to inspect the issuer's public accounting firm for three consecutive years.

Background: US exchanges received waivers from the SEC to allow Chinese companies to be listed on their exchanges. The Chinese companies have never complied with US auditing standards, nor are they subject to US auditing standards. The bill gives them three years to comply. Under normal conditions, when a company is delisted, its shares will trade in OTC markets or in the grays. The Senate bill has an OTC ban as well, so we are not sure exactly how it would work if a company were delisted based on such criteria. This is a developing situation that warrants our attention. Things move slowly in DC, until they don't. There are also secondary impacts to listed options on these securities, as well as ETFs that may hold them.

Recent SEC Actions indicate a return to normalcy

Actions from the SEC have shifted from being in a reactionary mode due to COVID-19 to a greater sense of normalcy. If you go back to just May 6, when the SEC voted to approve an order directing the exchanges and FINRA to draft a new NMS Plan with a modernized governance structure for consolidated market data, to as recently as today with its vote to adopt amendments which will improve financial disclosures on acquired businesses, you will see several other actions from the Commission which demonstrate a sense of normalcy.

Background: SEC May Press Releases

Fixed Income ETFs; When Market Structures Collide

Opening Remarks: Much is written about the electronification of the fixed income markets and the popularity of ETFs. The majority of individual fixed income products are traded in a dealer market where electronic executions are performed via an RFQ mechanism. ETFs are traded on equity exchanges where displayed prices can automatically be executed against in an efficient manner as measured by speed. The ETF mechanism, or wrapper, among other things allows investors to express an opinion on asset classes that historically have been difficult or impossible to access, such as commodities. With respect to fixed income ETFs, the extreme price moves and volatility experienced in late February did show what appeared to be price dislocations between the ETFs and their underlying fixed income holdings.

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Question #1:
Please talk about the activity in FI ETFs during the end of February and early March

Answer #1:
- Weekly volumes for US FI ETFs which encompass the nine major fixed income asset classes (corporates; Muni's; Gov't; bank loans; convertibles; TIPS; mortgage backed; preferreds; aggregate bonds) peaked in the week ending on March 6 where $222 bln in notional value traded hands, with $84 bln in Governments and $77 bln in Corporates.
- Primary to Secondary Ratio - which shows how much ETF creation/redemption activity there is versus what is traded - in March 2020 was consistent with historical averages of 23%. Some asset classes, like corporates, even saw lower ratios.
- Strong indication that traders were exchanging risk on the equity exchanges as opposed to touching the underlying assets.

Question #2:
With regard to corporate bonds, were there any liquidity issues with either the individuals bond or the ETFs? And were these liquidity issues a result of stale prices or just an absence of a buyers?

Answer #2
- Generally speaking, both. There were times where there were just no buyers or bids in the marketplace. Additionally, flaws in how certain third-party vendors value the prices on bonds resulted in some FI ETF trades appearing to be a steep discounts.
- Response rates on RFQ platforms along with customer hit/take rates during this late Feb/early March period appear to be similar to historical averages.
- The combination of the ETF mechanism and the electronification of fixed income trading have brought in a diverse range of client types as measured by investment strategies and geographical locations. Democratization.

Question #3
While there is empirical and anecdotal evidence that the FI ETF mechanism performed well during what were unprecedented market conditions, there were reports in the public domain which questioned the price dislocations on trades in the ETFs versus the underlying fixed income asset. Are these challenges bona fide? Do they create an impediment to or a catalyst for FI ETF growth?

Answer #3
Issues reside with the third-party pricing vendors. Participants are demonstrating a comfort and preference for trading FI ETFs on exchanges where there is price discovery and limited counterparty risk.

Question #4
Should there be changes to how fixed income assets trade?

Answer #4
Broadly speaking - as muni's trade differently than Governments; corporates, etc. - fixed income markets could benefit from certain features that exist in the equity markets, such as real-time reporting and firm quotes.