

# Incentives to Lose: Disclosure of Cover Bids in OTC Markets

Ordin & Sverchkov (2024)

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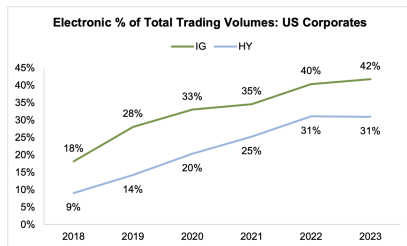
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## Motivation

- Over-the-Counter (OTC) markets are informationally **opaque** (Duffie (2012)).
- Corporate bond market features both *pre-trade* and *post-trade* transparency.  
⇒ Lack of available quotes (*pre-trade*) and information on transactions (*post-trade*).
- Electronic trading increases availability of price and quantity data post-trade.



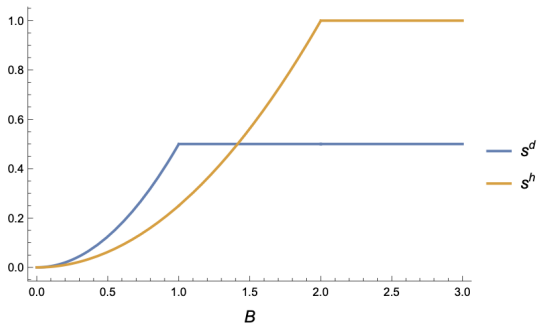
- However, market participants can query multiple dealers at the same time.  
⇒ Request-for-quote (RFQ); e.g. **MarketAxess** (Hendershott & Madhavan (2015)).
- Executed trades only part of the story, **losing bids** and failed search also valuable information, see e.g. **Kargar, Lester, Plante & Weill (2024)**.

## Research question and main results

- In an auction, the **cover** typically refers to the second highest bid.  
⇒ With **common values**, the cover contains valuable information for the winner.
- On RFQ platforms, investors can decide to disclose the cover to winning dealer.
- **Question(s)**: *What type of information does the cover provide? What determines whether an investor chooses or not to disclose the cover? How does this shape dealers' incentives to provide quotes?* The paper answers **all** these questions.
- Sequential first-price auction with one buyer; seller observes common value.
- Buyer learns about common value by direct disclosure or by losing the auction.  
⇒ Buyer knows prior to bidding whether seller will keep the common value secret.
- **Trade-off**: Secret common value raises seller surplus but invites lower quotes.  
⇒ Buyer has "incentive to lose" in order to learn the common value through reporting.
- Ex-post opacity **lowers welfare**; trades more likely to fail in the first period.
- Extensions: time-varying common value and  $T$ -period horizon.

## Disclosure driven by dealer's markups and uncertainty about bond value

- Dealers' value is the sum of a private component  $B$  and a common value  $v_t$
- Benefit  $B > 0$  captures markup on future resale prices; generates trading gains.  
⇒ As a result, trade is efficient; see also [Vairo & Dworzak \(2024\)](#).



**Summary:** *Seller's profit from hiding the cover higher when private benefits are large or when uncertainty about  $v_t$  is small. Cover hidden even if it invites higher quotes.*

## What do we know about investors who choose disclosure?

- Market participants can send anonymous or disclosed RFQs.  
⇒ Not just hide or disclose cover, also conceal trader identity and competition.

### Details

Platform offers two main trading protocols for US Corporate securities; an E-RFQ, and LOB/QS (Axes). Trading Hours are from 7PM-6PM EST (23 hours). Protocols are detailed as follows:

- **E-RFQs**

- The protocol allows for (a) Dealer to Buy-Side trading on a disclosed basis and (b) via Market Lists, All-to-All trading on an anonymous basis
- Initiator submits CUSIP, size, and determines recipients:
  - Disclosed: Participants can select pre-established Dealer relationships on a disclosed basis
  - Anonymous: Participants can choose Market Lists to send to all, or to specific groups of participants, on a fully anonymous basis
  - Both: Participants can select Dealer relationships (on a disclosed basis) and also send RFQ to Market List groups (anonymous) simultaneously
- Participants can select ASAP (all responses will appear on participant screen as they come) or Bin (all responses come at once at a specified time – not applicable for HY)
- Responders can submit live and executable quotes and include a specified good-till time, at which point the quote expires. Offers the option to negotiate as well
- Depending on if the RFQ is ASAP or Bin, the initiator can respond to quotes prior to expiration or at expiration and execute at selected level

- Roughly 50% of all electronic trades happen through **disclosed** RFQs (SIFMA).
- The trading venue is also a choice, see **Hendershott & Madhavan (2015)**.  
⇒ Trades executed electronically have different characteristics, e.g. liquidity and size.
- In the model, disclosure only depends on **dealer** and **bond** characteristics.
- **Question:** *What investor characteristics matter for the hide/disclose choice? Why are most of them willing to share so much information with the dealers?*

## Timing of disclosure

- Seller commits to hide or disclose the cover **prior** to observing the **common value**.
- Assumption implies disclosure decision **reveals nothing** about common value.  
⇒ If timing was reversed, decision to disclose potentially reveals information about  $v_t$ .
  
- **Question:** *Are the key implications robust to alternative timing assumptions?  
What if the seller observes the common value before deciding to disclose/hide?*
- The trading relation between buyer and seller is exogenous, so that  $B$  is fixed.
- Perhaps, decision to disclose cover can attract dealers with higher  $B$ ?

## Information structure and dealer characteristics

- The dealer has **no private information** about the value of the asset.
- Conversely, private benefit  $B > 0$  public knowledge; motivated e.g. by markups.  
⇒ Modeling approach similar to [Vairo & Dworzak \(2020\)](#); gains from trade.
  
- Private benefit  $B$  key determinant of decision to disclose or hide the cover.
- What if **sellers** cannot observe the dealers' private benefits from buying the asset?

## Implications for market design

- Because private benefits are positive,  $B > 0$  trade is efficient.
- Decision to hide the cover lowers welfare as trades more likely to fail (Prop. 5).
  
- **Questions:** *What are the implications for market design? Should RFQ protocols mandate disclosure of the cover if only total surplus matters?*
- Perhaps, disclosure mandates impact choice of trading venue and dealer networks.  
⇒ E.g. Hendershott & Madhavan (2015); Hendershott, Li, Livdan & Schürhoff (2019).
  
- What about **dealers**? Beck, Liu & Teguia (2020) "provide a theoretical rationale for dealer objections to ex-post transparency".
- Dealers may object to disclosure if it reveals private information about inventories.  
⇒ Beck et al. (2020) is about terms of trade of first transaction, not exactly the cover.
- *RFQ auctions more competitive when cover hidden? Any difference in bidding?*



## Connection to earlier literature on sequential auctions

- Conditional on disclose or hide; sequential common values FPA with one bidder.
- **Incentive to lose**: Dealer learns about common value by losing the first auction.
  
- Framework used to analyze post-trade transparency in OTC **bond markets**.  
⇒ Paper contributes to an extensive theoretical literature, see most recently [Vairo & Dworzak \(2024\)](#); [Baldauf & Möllner \(2024\)](#); [Back, Liu & Teguia \(2020\)](#).
- Yet, model sufficiently rich to deliver insights above and beyond the bond market.  
⇒ See e.g. [Dworczak \(2020\)](#) on designing mechanism and information structure jointly.
  
- *What other markets generate incentives to lose to learn about items being sold?*
- **Candidates**: repeated auctions of identical items with asymmetric information.  
⇒ What about eBay like auctions? Wine auctions? Timber auctions?

## Sequential auctions and auctions with resale

- The paper closely speaks to the finance literature on OTC trading.
  - Yet, connections to **sequential auctions** and auctions with **resale opportunities**.
  - The main distinction is that all trades are between the same buyer and seller.
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- **Question:** *To what extent do the model implications generalize to other settings?*
  - Literature on sequential auctions and information disclosure.  
⇒ Contracting with multiple principals: Calzolari & Pavan (2005); eBay-like auctions Song (2004).
  - Auctions with resale opportunities and aftermarket.  
⇒ Inter-bidder resale Haile (2003); Hafalir & Krishna (2008); cutoff rules Dworzak (2020).

## Minor comments

- Implication for price patterns: declining with disclosure and flat with hiding.  
⇒ Theoretical models typically imply **increasing** price path, see e.g. [Krishna \(2009\)](#).
- Can the model talk to the *declining price anomaly*? What do we see in the data?
  
- Gains from trade arise because of private benefits. How would heterogeneity in discount rates impact the results in the baseline model?
  
- The model studies dealer purchases. Would a sale be symmetric?
  
- Buyer can make a take-it-or-leave-it offer to the seller.  
⇒ No renegotiation: how would differences in bargaining power impact the results?

## Conclusion and open questions

- Great paper! I learned a lot; definitely a recommended read.
- Losing bids contain valuable information; explicitly model decision to disclose.
- Illustrate novel trade-off: seller surplus vs. lower quotes; incentive to lose.
  
- **Comment 1:** Hide/disclose driven by bond characteristics (value distribution) and fairly unobservable dealer characteristics (private benefits).  
*What do we know about the market participants who decide to hide the cover?  
Are there investor characteristics that can inform the model? Are the model implications robust to the timing assumptions?*
- **Comment 2:** Framework can potentially speak to more than the OTC literature; sequential auctions and resale opportunities.
  
- Good luck with the paper!