

# FEDERAL RESERVE BANK OF CHICAGO

CHARLES L. EVANS

President and Chief Executive Officer

May 5, 2016

Mr. David R. Pearl  
Office of the Executive Secretary  
Attention: Treasury Market RFI  
U.S. Department of the Treasury  
1500 Pennsylvania Avenue, N.W.  
Washington, D.C. 20220  
Submitted via electronic filing: [www.regulations.gov](http://www.regulations.gov)

Re: Notice Seeking Public Comment on the Evolution of the Treasury Market Structure  
(Docket No. TREAS–DO–2015–0013)

Dear Mr. Pearl:

The Federal Reserve Bank of Chicago appreciates the opportunity to comment on certain sections of the request for information (“RFI”) from the U.S. Department of the Treasury (“Treasury”) notice. We wholeheartedly agree with the Treasury’s effort to better understand the U.S. Treasury market structure and to assess the liquidity, trading and risk management practices in U.S. Treasury markets. Our specific comments, discussed below, are related to trading venue rules, reporting requirements, clearing arrangements, and regulation.

The U.S. Treasury market serves as primary means of financing the U.S. federal government and as a benchmark risk-free investment instrument for investors. In addition, the U.S. Treasury market, considered as the deepest and most liquid government securities market, plays an important role for the Federal Reserve’s implementation of monetary policy. Hence, it is extremely important to be cognizant of changes in market structure and liquidity provision in the U.S. Treasury marketplace.

There has not been a holistic market structure review of the U.S. Treasury markets since 1998<sup>1</sup> when the Treasury, Securities and Exchange Commission (“SEC”) and the Board of Governors of the Federal Reserve System (“Board”) concluded that the Government Securities Act Amendments (“GSAA”)<sup>2</sup> had addressed the major concerns facing the government

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<sup>1</sup> [http://www.treasurydirect.gov/instit/statreg/gsareg/gsareg\\_gsr98rpt.pdf](http://www.treasurydirect.gov/instit/statreg/gsareg/gsareg_gsr98rpt.pdf)

<sup>2</sup> Government Securities Act Amendments of 1993 was passed by Congress after the Treasury, SEC and Board studied the government securities market in the aftermath of the Salomon Brothers auction violations of 1990 and 1991 and submitted a very comprehensive report to Congress in January 1992.

securities market, and that there were no significant issues that would warrant seeking additional regulatory authority. However, recent events in the U.S. Treasury marketplace, such as the anomalous price behavior of October 15<sup>th</sup> 2014, have showcased the need for a thorough review of the market structure by the official sector. The “Joint Staff Report: The U.S. Treasury Market on October 15, 2014”<sup>3</sup> (“JSR”) provided an analysis of participant-level transaction data for that day and a characterization of firms actively participating in the market. The JSR has proven to be a good start in engaging the official sector with market participants to shed light on this complex and evolving market structure.

Broadly, the secondary markets for U.S. Treasuries can be categorized into two segments: cash<sup>4</sup> and futures. The U.S. Treasury futures market, traded at the Chicago Mercantile Exchange (“CME”), is a well-established marketplace, regulated by the U.S. Commodity Futures Trading Commission (“CFTC”), that has supported electronic trading since the late 1990s. The cash markets have been functioning in a decentralized dealer-to-client (DtC) and inter-dealer broker market (“IDB”) with light-touch regulation.

In the past decade, electronic trading has played an increasingly prominent role in the secondary U.S. Treasury cash market. Electronic trading is estimated to now represent more than half of the overall trading volume in the U.S. Treasury securities market.<sup>5</sup> Almost all trading of on-the-run Treasury securities in the inter-dealer market occurs electronically and majority of this trading occurs in an automated fashion. Trading in off-the-run Treasury securities is mainly a DtC market, is principal-to-principal dealer focused, and is conducted over voice channels and over electronic request-for-quotation (“RFQ”) platforms.<sup>6</sup> Unlike the futures markets, which are electronically traded on a single central limit order book (“CLOB”) and cleared via the CME clearing house, the cash market structure is fragmented – trading occurs on multiple IDB venues (notably BrokerTec and eSpeed platforms) with varying execution speeds and rules. Clearing for cash Treasuries occurs at the Fixed Income Clearing Corporation (“FICC”), but not all transactions from the cash markets are cleared via FICC.

Historically cash market transactions were dominated by bank-dealer entities. However, the recent JSR documents the increasing dominance of principal trading firms<sup>7</sup> (“PTFs”) in intra-day trading for on-the-run Treasuries. While high-speed, low-latency automated trading firms do a remarkable job of ensuring that any price anomalies are quickly arbitrated away, the presence of these firms leaves the market open to the possibility of rapid price moves, as seen

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<sup>3</sup> [https://www.treasury.gov/press-center/press-releases/Documents/Joint\\_Staff\\_Report\\_Treasury\\_10-15-2015.pdf](https://www.treasury.gov/press-center/press-releases/Documents/Joint_Staff_Report_Treasury_10-15-2015.pdf)

<sup>4</sup> Cash markets include on-the-run and off-the-run Treasury securities.

<sup>5</sup> Source: Greenwich Associates 2014 North American Fixed Income Study

<sup>6</sup> Treasury Market Practices Group’s (TMPG) White Paper on Automated Trading in Treasury Markets - [https://www.newyorkfed.org/medialibrary/microsites/tmpg/files/TMPG\\_June%202015\\_automated%20trading\\_w\\_hite%20paper.pdf](https://www.newyorkfed.org/medialibrary/microsites/tmpg/files/TMPG_June%202015_automated%20trading_w_hite%20paper.pdf)

<sup>7</sup> JSR defines PTFs as principal investors, deploying proprietary automated trading strategies, with low latency typically a key element of trading strategies. A PTF may be registered as broker-dealer but does not have clients as in a typical broker-dealer business model.

during the October 15<sup>th</sup> event<sup>8</sup>. Typical PTFs are not FICC members. Hence, their trades are not cleared by FICC. In contrast, most bank-dealers are FICC members and their trades are reported and cleared by the FICC.

### **Trading Venues**

As noted above, trading in U.S. cash treasury markets occur via multiple platforms and venues using various protocols<sup>9</sup>. A majority of on-the-run treasury securities are traded on Alternative Trading Systems (“ATS”) – BrokerTec and eSpeed – via CLOB protocol, and they host an infrastructure similar to an equities and/or futures exchange with sub-millisecond matching capabilities and co-location facilities. These platforms are registered broker-dealer entities with the SEC and are largely exempt from Regulation ATS. While these trading venues facilitate the price discovery function for U.S. Treasuries, they do not have the strict mandates of a regulated exchange. These venues also have very little public disclosure about order types, matching algorithms and self-trading statistics on their public website. **It is our position that all venues should describe their respective order types and trade matching logic in plain and simple English in an obvious place on their public websites.**

In today's automated, technology driven market, systems issues are an inevitable reality. The SEC has developed a regulatory framework, Regulation Systems Compliance and Integrity (“RegSCI”), to uphold the integrity and resilience of the systems that run the U.S. securities markets. It is unclear if IDB platforms trading U.S. Treasuries are required to comply with Reg SCI. **It is our position that IDB platforms like BrokerTec and eSpeed that are major price-discovery platforms for on-the-run Treasuries should be categorized as SCI entities and be subject to compliance with Reg SCI.**

### **Reporting Requirements**

**We recommend that regulators consider creating a consolidated audit trail or a centralized trade reporting facility for information on trades occurring in the U.S. Treasury cash markets.** The Financial Industry Regulatory Authority (“FINRA”) oversees TRACE, the central repository for U.S. corporate bond market. The SEC and FINRA both collect trade and quotes data for all Reg NMS U.S. stocks. In contrast, the U.S. Treasury market is almost two times the size of U.S. equity market and twenty times the size of the U.S. corporate bond market. Yet there is no central database reflecting the trading activities (messages, quotes, trades, etc.) in the U.S. Treasury market.

In a high-speed interconnected marketplace, information on quotes and matched trades is of paramount importance not just to the regulators but also to the public at large. **Timely, detailed and standardized trade reporting should be mandated by regulation for official**

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<sup>8</sup> On Oct 15<sup>th</sup> 2014, the yield on the benchmark 10-year Treasury security, a useful gauge for the price moves in other, related instruments, experienced a 37-basis-point trading range, only to close 6 basis points below its opening level.

<sup>9</sup> TMPG White Paper (June 2015), p. 3

sector use to monitor for any trading abuses and market manipulative practices. Trading venues should also provide the regulators with the raw tick-by-tick intraday information with the identity of the beneficiary owner of a trade for enforcement activities and research purposes.

On a daily basis, trading venues should also publically disseminate, for every CUSIP number, the open, high, low, and closing prices, as well as the number of transactions and the aggregate par amount traded. Where self-trading is permitted they should also be required to report for each CUSIP number the number of self-dealing transactions and aggregate par amount.

### Clearing Arrangements

**It is our position that clearing in U.S. Treasuries should be centralized and should be mandated by regulators.** To quote the CPSS-IOSCO Principles for Financial Market Infrastructures:

“...Financial Market Infrastructures have been shown to be an important source of strength in financial markets, giving market participants the confidence to fulfil their obligations on time, even in periods of market stress. In relation to CCPs, the objectives of safety and efficiency are even more pertinent because national authorities have required or proposed the mandatory use of centralized clearing in an increasing number of financial markets”<sup>10</sup>

In the current set-up, all primary dealers and the majority of bank-dealers are clearing members of FICC and much of the bank-dealer activity clears at FICC. On the other hand, there is no legal mandate for PTFs to clear via a CCP. As reported in the JSR, the PTF community has an increasing market share in the more liquid on-the-run Treasuries and plays a vital role in liquidity provision. However, the PTFs bilaterally clear their trades, and this increasing trend of bilateral clearing<sup>11</sup> goes unreported. These bilateral clearing arrangements may not be robust enough to handle an unexpected default of a non-clearing member in the cash markets and may impact bank-dealers or clearing members.

As in the futures markets, we believe that cash markets should also have central clearing mandates that will enable the CCPs access to superior pricing and trade data. CCPs will be in a better position to perform intraday surveillance and manage risks (via margining) to foster a stable, transparent and resilient Treasury market.

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<sup>10</sup> Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions, “Principles for Financial Market Infrastructures”, April, 2012, p. 11.

<sup>11</sup> DTCC Comment letter to U.S. Treasury RFI

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### **Regulatory Coordination**

The Treasury market has historically been a lightly regulated marketplace. Various regulatory agencies in the financial eco-system have some authority over selected parts of the U.S. Treasury markets, providing a degree of regulation of either the market center or the market participants. The Inter-Agency Working Group<sup>12</sup> (“IAWG”) for Treasury Market Surveillance monitors trading in the when-issued and other secondary markets for Treasury securities and Treasury futures markets. However, it is still unclear what authority primarily regulates the U.S. cash Treasury market and has the right to bring enforcement cases. A stylized view of these disparate regulatory relationships is shown in Figure 1 (below).

There are other forums like the Treasury Market Practices Group<sup>13</sup> (“TMPG”), a Federal Reserve Bank of New York sponsored group that make recommendations for best practices related to trading, settlement and risk management in the Treasury markets. **We recommend that the IAWG and the TMPG coordinate their efforts to harmonize the processes observed in the U.S. Treasury markets around trading, clearing and reporting requirements and conduct a comprehensive analysis of U.S. Treasury markets, including the complex regulatory structures found in these markets.**

We appreciate Department of Treasury’s work on these important matters and for the opportunity to provide input on the Treasury’s RFI. If you have any questions, you may contact Rajeev Ranjan at 312-322-6078 or John McPartland at 312-322-8118.

Sincerely,



Charles L. Evans

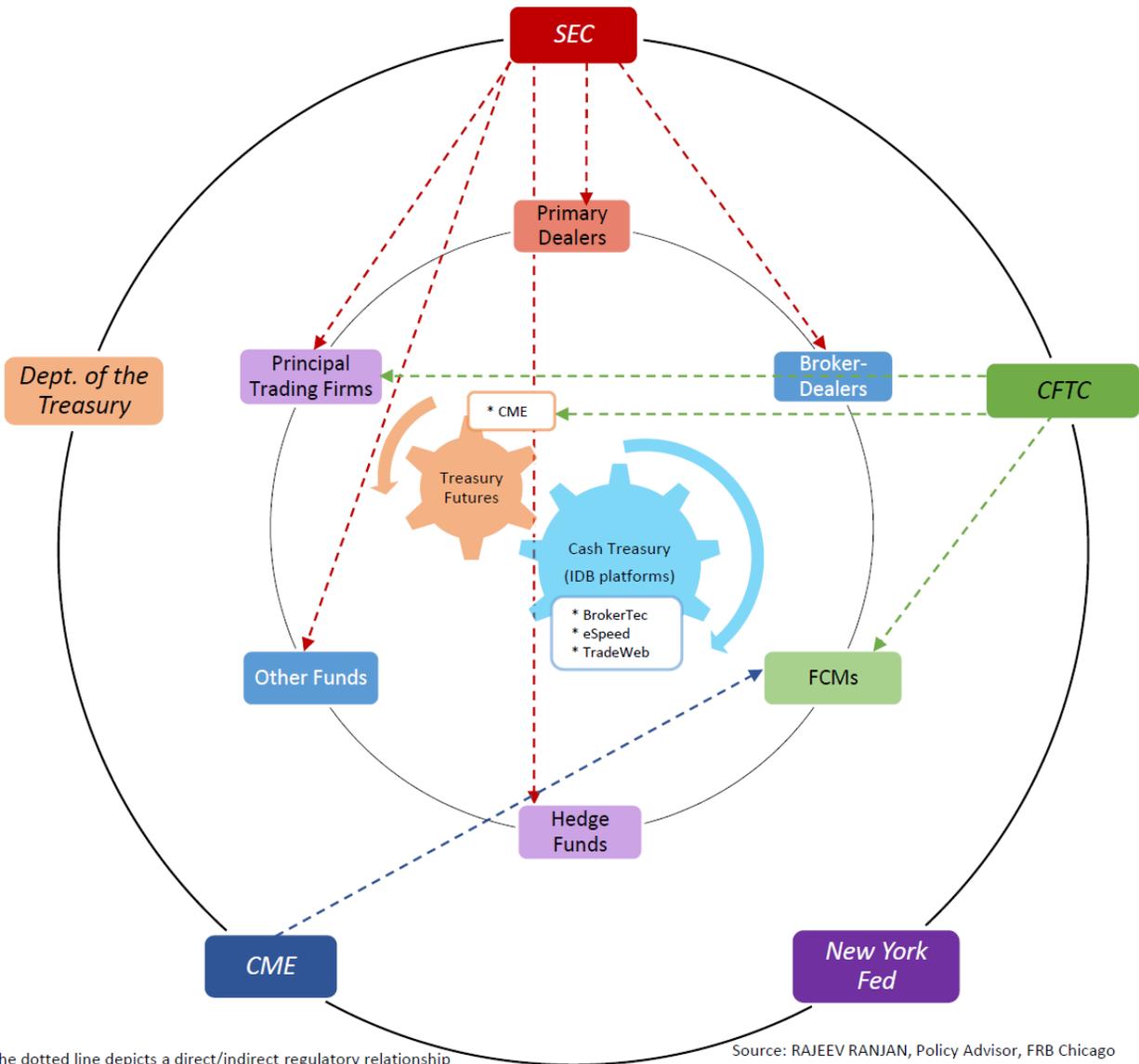
President and Chief Executive Officer

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<sup>12</sup> The IAWG comprises of Staff from the SEC, CFTC, Treasury, New York Fed and the Board of Governors of the Federal Reserve

<sup>13</sup> The TMPG is composed of senior business managers and legal and compliance professionals from a variety of institutions — including securities dealers, banks, buy-side firms, market utilities, and others. More details about the group is at - <https://www.newyorkfed.org/tmpg>

Figure 1



The dotted line depicts a direct/indirect regulatory relationship

Source: RAJEEV RANJAN, Policy Advisor, FRB Chicago